GOVERNMENT–SPONSORED ENTERPRISES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

MAY 14, 1990

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GOVERNMENT-SPONSORED ENTERPRISES

MONDAY, MAY 14, 1990

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 2 p.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
THURSDAY, APRIL 19, 1990

PRESS RELEASE #28
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
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THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON GOVERNMENT-SPONSORED ENTERPRISES

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will conduct a hearing to review reports to the Congress by the Department of the Treasury and the U.S. General Accounting Office on various issues relating to Federal debt management and government-sponsored enterprises. The hearing is scheduled for Monday, May 14, 1990 beginning at 2:00 p.m., in the main Committee hearing room, 1100 Longworth House Office Building.

Witnesses representing the Department of the Treasury and the U.S. General Accounting Office have been invited to present testimony at the hearing. Other interested parties are encouraged to submit written testimony to be included in the printed record of the hearing.

In announcing this hearing, Chairman Pickle stated: "Over the past several years, Committee Members have raised the concern that manipulation of Federal credit activities is becoming an inefficient, backdoor way of Federal spending and borrowing. In an attempt to better understand the impact of such off-budget Federally-assisted borrowing, the Congress, as part of the Financial Reform, Recovery, and Enforcement Act of 1989, required the Department of the Treasury and the U.S. General Accounting Office to make reports on the financial safety and soundness of government-sponsored enterprises and their impact on Federal borrowing.

"Analyses from the Department of the Treasury and the Congressional Budget Office indicate that government-sponsored enterprises have issued over $800 billion in outstanding loans or guarantees which have the implicit backing of the Federal Government, and that government-sponsored enterprise borrowing is estimated to make up nearly a third of all Federal or Federally-assisted borrowing activity in fiscal year 1991. This is a major allocation of credit in our national economy, and yet little, if any, attention has been given to the costs incurred by the Federal Government due to the risks it bears as a result of the activities of government-sponsored enterprises. Nonetheless, as a result of the savings and loan crisis and other recent situations, all Americans have become aware that Federal guarantees, whether they be implicit or explicit, have very real costs to the Treasury and the taxpayer.

"It is my expectation that these reports to the Congress from the Department of the Treasury and the U.S. General Accounting Office, and the testimony these agencies will present to the Subcommittee, will begin to provide the Congress, the Administration, and the public with the information and insight needed to properly utilize and manage Federal borrowing."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, June 1, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D. C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The Chair will ask our guests to please take their seats, and the committee will come to order.

The purpose of this hearing by the Subcommittee on Oversight is to receive reports from the Department of the Treasury and the U.S. General Accounting Office, based on their studies of the various risks associated with the operations of Government-sponsored enterprises, the so-called GSE's. This is the second hearing by the subcommittee in connection with these studies, and one of a series of hearings held by members of the Committee on Ways and Means in connection with the use of GSE's to finance Federal obligations or to further Federal policy in general.

I am glad to say that we have with us today Congressman Bill Gradison, who is a coauthor of the resolution we passed last year.

Recently, we have given a great deal of attention to these GSE's because they have become a fundamental part of the spending and borrowing policies of the Federal Government. Controlling the Federal budget is the most intractable problem the Federal Government has faced over the past decade. It has been so difficult to balance our Federal budget that we have had to pass a law, the Gramm-Rudman-Hollings Act, to compel us to do our jobs. And still, every year, the Congress and the administration agonize over the difficult choices which must be made. This year is no exception. Even as we meet, the leaders of Congress and the administration are holding budget summit meetings in an effort to keep the budget process on track.

Given all this concern about Federal spending and borrowing, it is surprising to me that so little attention is paid to the operations of GSE's. The fact of the matter is that GSE's represent the fastest-growing category of Federal credit assistance. They currently have issued over $800 billion in outstanding loans or guarantees, up from about $40 billion in 1970. The rate of growth in GSE obligations is nearly three times that of direct Federal borrowing over the past 20 years. Today, GSE borrowing represents about 33 percent of all Federal or federally assisted borrowing activity.

Further, there is no end in sight to this mushrooming volume of GSE borrowing. To the contrary, as a result of the passage of the Gramm-Rudman-Hollings Act, and our attempt to impose some budget discipline on direct Federal expenditures, there is a heightened interest in using off-budget GSE's. Since the beginning of 1987, five new GSE's have been created. Two of them, FICO and REFCORP, were to pay for the savings and loan fiasco, and two others, FAC and Farmer Mac, were created in connection with the bailout of the farm credit system. Proposals have also been advanced to create several other new GSE's. Last year, the administration gave serious consideration to chartering a GSE to raise tens of billions of working capital which the Resolution Trust Corporation believes will be needed during the course of resolving the savings and loan crisis, and Congress is giving consideration to creating other GSE's, to provide credit for small business venture capital and earthquake reinsurance.

Now, we ought to be honest and open and want to say also that GSE's can and do serve as a very useful source of needed credit, so we should recognize that. And yet, in spite of the enormous volume of explosive growth in the issues of GSE obligations and the cre-

ation of new GSE's, there have been to date little or no analysis of the risks of these activities to the Federal Treasury, and ultimately, the taxpayers. Perhaps those risks are remote. Perhaps my concerns are overstated. Perhaps. But, when the Federal Government has in effect cosigned an open-ended note which is over $800 billion and climbing, it is not unreasonable to ask for a little accountability.

The sad truth is that there has been little or no accountability here for a long time. Budget Director Darman has characterized the GSE liabilities as not being fully visible. He describes them as "like a hidden Pac Man waiting to spring forward to consume another line of resource dots in the budget maze."

The Congressional Budget Office has warned that, "the practice of neither measuring nor controlling the risks of GSE's could lead, if continued, to large and unanticipated Federal outlays." The General Accounting Office has, on several occasions, cautioned the Congress about the lack of effective oversight over the operation of GSE's. The Department of the Treasury has alerted us to the potential use of GSE's as a means of avoiding budget discipline, and the Gramm-Rudman-Hollings Act itself also noted that the potential losses associated with GSE's are not just theoretical possibilities. Throughout the 1980's, financial institutions have demonstrated the ability to lose vast amounts of money, and their creditors have repeatedly turned to the Federal Government for Federal assistance. The bailout of the farm credit system and, of course, the current Federal savings and loan disaster, should be sobering lessons to anyone who advocates allowing private institutions unfettered use of Federal credit. Taxpayers should not and will not be expected to pay for the wretched excesses and dismal failures of some of our private financial institutions.

It appears to me that we have been amply warned regarding the potential risks and abuses of GSE's. Our challenge is to react appropriately to these warnings, and to avoid taking unnecessary risks. It is my hope these studies will provide the basis on which the Congress, administration and the GSE's can act to address these risks responsibly.

Let me conclude with saying it is not my intention today to propose or support specific measures to reduce the risk associated with GSE's, but as we learn more about the risk they pose, I would expect that careful consideration be given to reform, which might better protect Treasury and the taxpayer. It seems to me that there are three areas are areas which ought to receive close attention, and they are disclosure, capital, and supervision. Disclosure to ensure that the Federal Government and the public financing market have timely information needed to correctly assess the risk. Capital to ensure that those that invest in and benefit from GSE's bear a commensurate share of the risk. Supervision to ensure the Federal Government, which is ultimately responsible for the condition of the American economy, has the ability to examine and control various GSE's as they are created, when their operation begins to involve excessive risk to the taxpayer.

I do not know of any imminent crisis about to befall any GSE. But, I am here to tell you ignorance is not bliss, the time to gather information and ask hard questions is now, when we can limit our

losses, and not after a disaster, when we can only fight about who must pay the piper.

I am going to ask Mr. McGrath if he has any opening statement?

Mr. MCGRATH. I do.

Mr. Chairman, I am pleased to join you in opening our hearing on Government-sponsored enterprises. Last September, our subcommittee held its first hearing on GSE's. It was a real eye-opener. It showed that GSE's have over $800 billion of outstanding debt which is guaranteed implicitly by the Federal Government.

A serious financial downturn could lead to GSE down the road to a failure, similar to the recent savings and loan collapse. The Federal Government and taxpayers would then be called upon to bail out the GSE in order to prevent the nationwide financial shock wave.

Our last hearing surveyed the GSE landscape, and we asked a lot of questions, but we did not get a lot of answers. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 directed the Treasury to conduct several studies on the safety and soundness of GSE's.

Today, we will receive the first Treasury Department study on GSE's. And hopefully will provide the answers to the questions which we raised last year.

The recurring question is, what is the adequate level of core capital required by each GSE to protect the Federal Government from having to make good on its implicit guarantee of GSE net? The answer will vary from GSE to GSE, because each one has a different programmatic risk. The Treasury Department study should help us set the framework to develop the proper capital standards for each GSE.

Mr. Chairman, in the past, the attitude toward GSE's was, if it ain't broke, don't fix it. That attitude may be good for lawn mowers, but not for GSE's, with an implicit claim on $800 billion of Federal taxpayer dollars.

My fear is that when a disaster strikes, it may be too late to take effective preventive measures. Therefore, we should develop strong safeguards to assure the soundness of GSE financing operations now.

Mr. Chairman, I look forward to learning the results of the Treasury Department's study on GSE.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. McGrath.

Mr. Gradison is the coauthor of the resolution which was embodied in part of the FIRREA legislation, and we are pleased to have him with us today. Mr. Gradison, would you like to make a statement?

Mr. GRADISON. Thank you, Mr. Chairman.

I am happy to join with you and Mr. McGrath at this hearing. I believe this is an important milestone and progress in ensuring adequate oversight not just by the Congress but also by the executive branch, most particularly the Treasury, in light of the rapid growth in the obligations of the GSE's.

As I think about it, it seems to me that it is a fair analogy to suggest that Treasury's role in this situation should be that of a credit officer of a bank which is guaranteeing loans.

Basically, if the loans don't pan out, the Treasury, on behalf of the Government, ends up picking up the tab. The first step, of course, is these studies, which I am sure will be very useful to us.

I was delighted that we were able to succeed in Congress in getting 2 years of studies written in the FIRREA legislation. I was disappointed it was not made a permanent requirement, because it seems to me to put the best face on this. If everything is fine right now, it doesn't assure it always will be.

The best protection we have of adequate oversight will be a continuing evaluation of capital adequacy by the Treasury itself. My own approach on this isn't at this stage to have in mind a particular amount of capital for each of the GSE's, but to suggest that that is what we should be seeking to determine. And further, that once we determine what the minimum capital cushion should be, that we should require that it be increased by another 1 or 2 points to give some comfort level to the lender.

I do not approach this from the point of view that we should just figure out what is the absolute minimum that probably will get us through most circumstances. I am not suggesting, because I don't believe this, that the percentages that we have required under FIRREA for thrift institutions are the proper percentage. It is a different situation.

I believe as has been pointed out already by Mr. McGrath, that the appropriate requirements will vary from entity to entity. I do hope as we move ahead on this, that we do not approach it from trying to come up with the lowest common denominator that will put the issue behind us.

I don't see it that way. I see it as a continuing responsibility of all involved. I believe that once an appropriate level of capital is set, that in effect will provide whatever limit is necessary, at least a year at a time with regard to borrowing authority.

I am not sure it is necessary or even appropriate to try to figure out in advance a specific amount of debt. I would rather focus on the capital, and then whether the amount of borrowing would be a function of that measurement.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Gradison.

Our first witness, then, this afternoon will be the Honorable Robert R. Glauber, Under Secretary of the Treasury for Finance. Mr. Glauber has been with us before. With him is Michael Basham, Deputy Assistant Secretary for Federal Finance. Mr. Basham testified previously. We are pleased to have both of you gentlemen.

If you will proceed?

STATEMENT OF HON. ROBERT R. GLAUBER, UNDER SECRETARY OF THE TREASURY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY MICHAEL E. BASHAM, DEPUTY ASSISTANT SECRETARY FOR FEDERAL FINANCE

Mr. GLAUBER. Thank you very much, Mr. Chairman.

Thank you for inviting us. With your permission, I would like to read excerpts.

Chairman PICKLE. If you want to give the testimony, it will be agreeable. I have had a chance to look at it. I think it is good testi-

mony, and you just take your time for the record. If you do go from paragraph to paragraph, try to tell us where you are.

Mr. GLAUBER. I will. I think I will only omit one or two paragraphs.

Mr. Chairman and members of the subcommittee, it is a pleasure to be here today to discuss the results of Treasury's first study of Government-sponsored enterprises or GSE's.

The recent failure of many federally insured savings and loan institutions, and the massive Federal funding required to resolve the thrift problem, have focused attention on other areas in which the Government may be exposed to financial risks. In this connection, section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, FIRREA, directs the Secretary of the Treasury to assess, in two annual studies, the financial safety and soundness of GSE's.

While we had planned to submit the study today, the need to incorporate significant new information from two of the GSE's has resulted in some delay. We will submit the first study to Congress later this month.

Chairman PICKLE. Mr. Secretary, may I interrupt you? Is it important to know which two are submitting new information?

Mr. GLAUBER. In the case of Fannie Mae, we received some new data describing their portfolio, which we felt was important to incorporate in our analyses and have done so.

In the case of Connie Lee, we received further amplification of their underwriting standards which, again, we felt was important.

Because our individual analyses are not available, in fairness to the GSE's, I will not comment today on the specific financial safety and soundness of the individual GSE's. Our comments in this area will, of course, be included in the full study.

Government-sponsored enterprises are entities which have been established and chartered by the Federal Government to perform specific credit functions, but are now, with one exception, entirely privately owned. GSE's generally serve as financial intermediaries to facilitate the flow of credit to private borrowers in three major areas: One, agriculture; two, housing; and, three, higher education. They do this by raising funds in the capital markets to make or purchase loans, by issuing passthrough securities, or by guaranteeing the liabilities of others. The GSE's included in this study had borrowed or guaranteed $768 billion by the end of fiscal year 1989.

Let me, with your permission, Mr. Chairman, skip the next paragraph.

The market's perception of Federal backing for GSE's weakens the normal relationship between the availability and cost of funds to the GSE's and the risks that these enterprises assume. The GSE's have the opportunity and even the incentive to seek greater rewards by taking more risk. Any benefits of this higher level of risk accrue to the stockholders of the GSE's, and, to a greater or lesser extent, their targeted constituencies. The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE-guaranteed securities from loss, and providing equity investors with higher potential returns because of the greater than normal leverage some GSE's are able to assume. The

asymmetry of this relationship with the Government makes it incumbent upon Congress and the administration to scrutinize closely the financial stability of the GSE's and the risks associated with their activities.

Again, may I skip the next one?

Because the primary concern of the study is the financial safety and soundness of each GSE, it focuses on issues which could result in the exposure of the Government to excessive levels of risk. No effort has been made in the study to determine whether the Congressional intent of each GSE is being met. Treasury did not conduct a cost-benefit analysis to determine if the GSE's are efficiently passing the benefits of their GSE status and the resulting credit advantages through to the targeted beneficiaries: housing, agriculture and education.

It is important to note that Treasury did not perform an audit of any financial information or test for compliance to the GSE's' policies, procedures and internal controls. We relied instead on the accuracy of the information presented to us by the GSE's.

President Bush, in his fiscal year 1991 budget, gave recognition to the underwriting risks associated with Federal credit subsidies. He suggested that "structural reforms and better incentives for evaluating credit risk can preserve the benefits of Federal credit programs while avoiding excessive Federal risk." In light of the desire of the administration and Congress to establish guidelines to improve the safety and soundness of GSE's and as a result of our analysis of the GSE's, the Treasury proposes the following guiding principles and recommendations in order to minimize the potential risk of another costly Federal rescue.

Principle 1: A GSE should be adequately capitalized, meet high credit and operational standards, and be subject to effective Government supervision or Congress should terminate all Government ties with the GSE.

GSE's are in an unusual position. While other corporations are able to diversify their operations, GSE's are mandated to serve specific credit needs in a single business area, which makes them particularly vulnerable to economic downturns in these areas. Furthermore, the financial risks inherent in institutions of this size pose a greater systemic risk that cannot be completely hedged or eliminated. A clear understanding of these risks and of the need to balance them against the importance of achieving desired public policy goals underscores the need to establish incentives for GSE's to operate in a safe and sound manner and with prudent and effective supervision.

Some GSE's are among the most thinly capitalized of major U.S. financial entities. Unlike other private sector corporations, GSE's are not subject to the usual market-imposed disciplines of increased cost or reduced access to capital as their balance sheet leverage increases beyond normally prudent levels. This is due to the market's perception of a unique and special relationship to the Federal Government. Market participants believe that if a GSE experiences extreme financial difficulties, Congress would step in to ensure that debt holders and investors in GSE-guaranteed securities would experience no losses.

As a result of this market perception, GSE's are able to borrow in the market at rates higher than the Treasury itself pays, but significantly lower than AAA-rated corporations. In addition, they are able to employ much greater leverage in their activities; considerably higher than corporations that do not benefit from any special ties to the Federal Government. This ability to employ greater balance sheet leverage results in significantly higher returns for shareholders when a GSE is successful, but it can result in tremendous pressure for Government assistance if a GSE encounters financial difficulty. This is similar to what happened with the farm credit system a few years ago, and very similar to the problems of excessive risk-taking that occurred in the thrift industry.

To correct for the bias toward excessive risk in the GSE's' existing incentive structure, each GSE should be required to, one, have a significant amount of its own capital at risk so that it absorbs any losses first, and has a strong incentive to monitor and control its risks; two, meet high credit and operations standards; and, three, be subject to effective Federal supervision.

If these conditions are not met by a GSE, Congress should sever that GSE's ties with the Government.

Principle 2: A private market mechanism should be used to evaluate GSE risk.

While each of the GSE's was authorized by Congress for a specific public purpose and to serve a specific constituency, each operates as a private corporation with shareholders. Over the years, the GSE's have grappled with how best to reconcile the often opposing goals of fulfilling their federally mandated public purpose and delivering the financial returns expected by shareholders.

As discussed earlier, the GSE's are not subject to all of the usual market forces that impact the activities of other corporations. The GSE's' shareholders and, to some extent, the intended beneficiaries have gained from this arrangement. Shareholders have received greater returns on equity in part because GSE's have been able to operate with much greater leverage than other corporations. Targeted constituencies have also benefited because the lack of normal market restraints has allowed GSE's to expand their programs dramatically and to offer financing at reduced costs.

After careful review of the capital adequacy and other management and financial factors essential to safety and soundness, the Treasury has determined that no single capital adequacy test or standard can or should apply to all GSE's, due to the diversity and complexity of their operations. For example, forcing compliance of each GSE with the risk-based capital standards for commercial banks or thrifts would not be sensible. While the amount of equity capital is an essential element of safety and soundness, it is not the only one; other important factors need to be taken into account as well.

The private sector turns to private credit rating agencies when faced with a need to measure and monitor the risks of complex and broadly different commercial entities. These agencies are able to focus on the full range of factors that affect creditworthiness, not just capital adequacy. We believe that the approach used to evaluate and monitor risks in private markets can and should be used to evaluate GSE risk. This approach provides a superior method for

evaluating risk than a reliance on a single capital adequacy standard.

Toward this end, the Treasury recommends that GSE's be required to obtain a rating equivalent to AAA, absent any implicit Government guarantee, from at least two of the nationally recognized credit rating agencies. Each GSE would be required to obtain a rating shortly after enactment of legislation incorporating these recommendations. Should a GSE be rated below AAA, it would be required to submit, and adhere to, an acceptable business plan describing the actions it plans to take to achieve a AAA rating within 5 years from the date of enactment of the legislation, or lose its ties to the Federal Government.

Treasury is convinced that a AAA rating is appropriate because it represents the most safe and sound level of credit quality, and thereby the best protection from potential risk. It should be noted that requiring this high credit standard should not increase the borrowing costs of any GSE, nor would it significantly impair the ability of GSE's to fulfill their public purpose. In fact, requiring a AAA rating would only reduce the potential need for another Federal rescue.

Principle 3: The program regulator should be different from the implementer of financial safety and soundness standards.

Treasury recommends that the regulatory authority which monitors a GSE's fulfilment of its congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will minimize risk to the taxpayers by removing a perceived or actual regulatory conflict of interest. That is why FIRREA divided the thrift regulator's chartering and chief supervisor functions from its insurance function, assigning the former to the Office of Thrift Supervision and the latter to the FDIC.

The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its congressional mandate by effectively serving its intended beneficiaries. For example, the Department of Housing and Urban Development would continue to exercise specific and general regulatory oversight over housing-related GSE's, including new program approval, and provide assurance that they meet their obligation to provide ongoing assistance to the secondary market for home mortgages for low- and moderate-income families.

The Treasury recommends that issues related to financial safety and soundness be dealt with by a different Federal entity, one that would ensure that the GSE meets the requirements for a AAA rating. In the event a GSE is not rated AAA, this entity would certify a business plan designed to achieve the required credit rating and monitor adherence to the plan.

If the business plan were not adhered to, the safety and soundness implementer would be authorized to impose sanctions that include limiting GSE growth, establishing additional financial constraints, such as dividend restrictions or reduced financial leverage, and withdrawing certain benefits of Government sponsorship, such as SEC exemption, Federal charter, use of its obligations as Federal deposit collateral, and unlimited investment in its obligations by depository institutions.

Principle 4: The value of the Government's financial support should be disclosed.

The use of the credit rating agencies will provide important data for estimating the size of the implicit Federal subsidy available to each GSE. For example, if a GSE were rated A absent a Government guarantee, the interest rate portion of the subsidy would be the difference between the interest rate at which A-rated corporations can borrow in the market, and the interest rate the GSE pays. Even after such GSE attained AAA status, a significant credit subsidy not enjoyed by private sector competitors would still remain. GSE's enjoy other financial advantages as well, but these do not all lend themselves as readily to calculation, nor is their magnitude of effect comparable.

Congress and the public should be aware of the size of the subsidy, as well as all the other advantages GSE's receive, to be better able to analyze the true costs of GSE programs compared to the benefits the targeted beneficiaries actually receive. The administration recommends the amount of subsidy that results from a GSE's enhanced borrowing status be disclosed annually as a part of the President's budget.

The guiding principles and recommendations that the Treasury has proposed will assist the Government in managing its responsibility to ensure that the GSE's meet their congressional mandates in a safe and sound manner. The Treasury believes that the steps outlined here will enhance safety and minimize risk to taxpayers, while maintaining the GSE's' ability to efficiently and effectively serve America's special credit needs.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

[The statement of Mr. Glauber follows:]

FOR RELEASE ON DELIVERY
EXPECTED AT 2:00 P.M.
May 14, 1990

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss the results of Treasury's first study of Government-sponsored enterprises or GSEs.

The recent failure of many federally insured savings and loan institutions, and the massive Federal funding required to resolve the thrift problem, have focused attention on other areas in which the Government may be exposed to financial risks. In this connection, section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directs the Secretary of the Treasury to assess, in two annual studies, the financial safety and soundness of GSEs.

While we had planned to submit the study today, the need to incorporate significant new information from two of the GSEs has resulted in some delay. We will submit the first study to Congress later this month. Because our individual analysis are not available, in fairness to the GSEs, I will not comment today on the specific financial safety and soundness of the individual GSEs. Our comments in this area will, of course, be included in the full study.

Government-sponsored enterprises are entities which have been established and chartered by the Federal Government to perform specific credit functions, but are now, with one exception, entirely privately owned. GSEs generally serve as financial intermediaries to facilitate the flow of credit to private borrowers in three major areas: (1) agriculture, (2) housing, and (3) higher education. They do this by raising funds in the capital markets to make or purchase loans, by issuing pass-through securities, or by guaranteeing the liabilities of others. The GSEs included in this study had borrowed or guaranteed $768 billion by the end of fiscal year 1989.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of guaranteed loans and borrowing by GSEs. Yet, as indicated in the President's Budget for Fiscal Year 1991, off-budget borrowing under Federal auspices actually exceeded Federal borrowing to finance the budget deficits in fiscal years 1987 and 1989. Moreover, borrowing by all GSEs alone is projected to exceed Federal borrowing in fiscal 1991.

The market's perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of

funds to the GSEs and the risks that these enterprises assume. The GSEs have the opportunity and even the incentive to seek greater rewards by taking more risk. Any benefits of this higher level of risk accrue to the stockholders of the GSEs and, to a greater or lesser extent, their targeted constituencies. The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE-guaranteed securities from loss, and providing equity investors with higher potential returns because of the greater than normal leverage some GSEs are able to assume. The asymmetry of this relationship with the Government makes it incumbent upon Congress and the Administration to scrutinize closely the financial stability of the GSEs and the risks associated with their activities.

The Treasury used a case study approach to examine each of the GSEs according to the requirements detailed under FIRREA. Each study discusses briefly the history and development of the GSE, contains a detailed analysis of its financial safety and soundness, and discusses the timeliness and quality of information that it provides to the public and the Federal Government. The analysis of each GSE's safety and soundness focused on business risk, credit risk, interest rate risk, and management and operations risk. In addition, Treasury analyzed the level of capital each GSE maintains.

Because the primary concern of the study is the financial safety and soundness of each GSE, it focuses on issues which could result in the exposure of the Government to excessive levels of risk. No effort has been made in the study to determine whether the Congressional intent of each GSE is being met. Treasury did not conduct a cost/benefit analysis to determine if the GSEs are efficiently passing the benefits of their GSE status and the resulting credit advantages through to the targeted beneficiaries -- housing, agriculture and education.

It is important to note that Treasury did not perform an audit of any financial information or test for compliance to the GSEs' policies, procedures, or internal controls. We relied instead on the accuracy of the information presented to us by the GSEs.

President Bush, in his FY 1991 Budget, gave recognition to the underwriting risks associated with Federal credit subsidies. He suggested that "structural reforms and better incentives for evaluating credit risk can preserve the benefits of Federal credit programs while avoiding excessive Federal risk". In light of the desire of the Administration and Congress to establish guidelines to improve the safety and soundness of GSEs and as a result of our analysis of the GSEs, the Treasury proposes the following guiding principles and recommendations in order to minimize the potential risk of another costly Federal rescue.

Principle 1: A GSE Should Be Adequately Capitalized, Meet High Credit and Operational Standards, and Be Subject to Effective Government Supervision or Congress Should Terminate All Government Ties with the GSE.

GSEs are in an unusual position. While other corporations are able to diversify their operations, GSEs are mandated to serve specific credit needs in a single business area, which makes them particularly vulnerable to economic downturns in these areas. Furthermore, the financial risks inherent in institutions of this size pose a greater systemic risk that cannot be completely hedged or eliminated. A clear understanding of these risks and of the need to balance them against the importance of achieving desired public policy goals underscores the need to establish incentives for GSEs to operate in a safe and sound manner and with prudent and effective supervision.

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Some GSEs are among the most thinly capitalized of major U.S. financial entities. Unlike other private sector corporations, GSEs are not subject to the usual market-imposed disciplines of increased cost or reduced access to capital as their balance sheet leverage increases beyond normally prudent levels. This is due to the market's perception of a unique and special relationship to the Federal Government. Market participants believe that, if a GSE experiences extreme financial difficulties, Congress would step in to ensure that debt holders and investors in GSE-guaranteed securities would experience no losses.

As a result of this market perception, GSEs are able to borrow in the market at rates higher than the Treasury itself pays, but significantly lower than triple-A rated corporations. In addition, they are able to employ much greater leverage in their activities; considerably higher than corporations that do not benefit from any special ties to the Federal Government. This ability to employ greater balance sheet leverage results in significantly higher returns for shareholders, when a GSE is successful, but it can result in tremendous pressure for Government assistance if a GSE encounters financial difficulty. This is similar to what happened with the Farm Credit System a few years ago and very similar to the problems of excessive risk-taking that occurred in the thrift industry.

To correct for the bias toward excessive risk in the GSEs' existing incentive structure, each GSE should be required to:

(1) have a significant amount of its own capital at risk so that it absorbs any losses first, and has a strong incentive to monitor and control its risks;

(2) meet high credit and operations standards; and

(3) be subject to effective Federal supervision.

If these conditions are not met by a GSE, Congress should sever that GSE's ties with the Government.

Principle 2: A Private Market Mechanism Should Be Used to Evaluate GSE Risk.

While each of the GSEs was authorized by Congress for a specific public purpose and to serve a specific constituency, each operates as a private corporation with shareholders. Over the years, the GSEs have grappled with how best to reconcile the often opposing goals of fulfilling their federally mandated public purpose and delivering the financial returns expected by shareholders.

As discussed earlier, the GSEs are not subject to all of the usual market forces that impact the activities of other corporations. The GSEs' shareholders and, to some extent, the intended beneficiaries have gained from this arrangement. Shareholders have received greater returns on equity in part because GSEs have been able to operate with much greater leverage than other corporations. Targeted constituencies have also benefited because the lack of normal market restraints has allowed GSEs to expand their programs dramatically and to offer financing at reduced costs.

After careful review of the capital adequacy and other management and financial factors essential to safety and soundness, the Treasury has determined that no single capital adequacy test or standard can or should apply to all GSEs, due to the diversity and complexity of their operations. For example, forcing compliance of each GSE with the risk-based capital standards for commercial banks or thrifts would not be sensible. While the amount of equity capital is an essential element of

safety and soundness, it is not the only one; other important factors need to be taken into account as well.

The private sector turns to private credit rating agencies when faced with a need to measure and monitor the risks of complex and broadly different commercial entities. These agencies are able to focus on the full range of factors that affect creditworthiness, not just capital adequacy. We believe that the approach used to evaluate and monitor risks in private markets can and should be used to evaluate GSE risk. This approach provides a superior method for evaluating risk than a reliance on a single capital adequacy standard.

Toward this end, the Treasury recommends that GSEs be required to obtain a rating equivalent to triple-A, absent any implicit Government guarantee, from at least two of the nationally recognized credit rating agencies. Each GSE would be required to obtain a rating shortly after enactment of legislation incorporating these recommendations. Should a GSE be rated below triple-A, it would be required to submit, and adhere to, an acceptable business plan describing the actions it plans to take to achieve a triple-A rating within five years from the date of enactment of the legislation, or lose its ties to the Federal Government.

Treasury is convinced that a triple-A rating is appropriate because it represents the most safe and sound level of credit quality, and thereby the best protection from potential risk. It should be noted that requiring this high credit standard should not increase the borrowing costs of any GSE, nor would it significantly impair the ability of GSEs to fulfill their public purpose. In fact, requiring a triple-A rating would only reduce the potential need for another Federal rescue.

Principle 3: The Program Regulator Should Be Different from the Implementer of Financial Safety and Soundness Standards.

Treasury recommends that the regulatory authority which monitors a GSE's fulfillment of its Congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will minimize risk to the taxpayers by removing a perceived or actual regulatory conflict of interest. That is why FIRREA divided the thrift regulator's chartering and chief supervisor functions from its insurance function, assigning the former to the Office of Thrift Supervision and the latter to the FDIC.

The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its Congressional mandate by effectively serving its intended beneficiaries. For example, the Department of Housing and Urban Development would continue to exercise specific and general regulatory oversight over housing related GSEs, including new program approval, and provide assurance that they meet their obligation to provide ongoing assistance to the secondary market for home mortgages for low- and moderate-income families.

The Treasury recommends that issues related to financial safety and soundness be dealt with by a different Federal entity, one that would ensure that the GSE meets the requirements for a triple-A rating. In the event a GSE is not rated triple-A, this entity would certify a business plan designed to achieve the required credit rating and monitor adherence to the plan.

If the business plan were not adhered to, the safety and soundness implementer would be authorized to impose sanctions that include limiting GSE growth, establishing additional financial constraints (such as dividend restrictions or reduced financial leverage), and withdrawing certain benefits of

Government sponsorship (such as SEC exemption, Federal charter, use of its obligations as Federal deposit collateral, and unlimited investment in its obligations by depository institutions).

Principle 4: The Value of the Government's Financial Support Should Be Disclosed.

The use of the credit rating agencies will provide important data for estimating the size of the implicit Federal subsidy available to each GSE. For example, if a GSE were rated single-A absent a Government guarantee, the interest rate portion of the subsidy would be the difference between the interest rate at which single-A rated corporations can borrow in the market, and the interest rate the GSE pays. Even after each GSE attained triple-A status, a significant credit subsidy not enjoyed by private sector competitors would still remain. GSEs enjoy other financial advantages as well, but these do not all lend themselves as readily to calculation, nor is their magnitude of effect comparable.

Congress and the public should be aware of the size of the subsidy, as well as all the other advantages GSEs receive, to be better able to analyze the true costs of GSE programs compared to the benefits the targeted beneficiaries actually receive. The Administration recommends the amount of subsidy that results from a GSE's enhanced borrowing status be disclosed annually as a part of the President's budget.

The guiding principles and recommendations that the Treasury has proposed will assist the Government in managing its responsibility to ensure that the GSEs meet their Congressional mandates in a safe and sound manner. The Treasury believes that the steps outlined here will enhance safety and minimize risk to taxpayers, while maintaining the GSEs' ability to efficiently and effectively serve America's special credit needs.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

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Chairman PICKLE. Well, Mr. Secretary, I want to thank you for your testimony and for your specific recommendations.

Before I go into commentary on your specific recommendations, I do want to commend you on this very thorough study and innovative package you put together for us. I wish we had your full report today, but based on the two caveats you pointed out about new information you received, we accept this delay. I am sure a lot of people will be waiting for this report. Many of them are in this room.

I understand the report is about 500 pages long, so I know that that will take some addition study, but I understand you are going to get that out within the month, by the end of this month.

Mr. GLAUBER. That is correct.

Chairman PICKLE. Now, before we receive the full report, I think it is clear from your testimony that you are making some specific and extremely important recommendations in the form of principles.

I think your remarks cover the various questions we ask of you when we passed the resolution and put it in FIRREA. I think you have been responsive to it. I would say I think if all this sounds like praise, Mr. Secretary, I hope you accept it as such, because these are strong principles.

Now, let me ask you a question, first and foremost, and this is a matter of record, as much as anything. You have given us these recommended principles, and you will have the full study out later. Can you tell me when the full report will be released? Can I assume it will be issued by the end of this month?

Mr. GLAUBER. That is our intention at this point. It is going through the final clearance process.

Chairman PICKLE. I accept your reason for the delay, but I want to ask you, are these principles, or these recommendations that you are making today, are they final, or are they just preliminary?

Mr. GLAUBER. I believe that they are final and will be incorporated in the final report. We have completed our analysis, and it rests, of course, on the data that we have available. Assuming we receive no further data, and I don't expect we will, these should rest as final.

Chairman PICKLE. The reason I am asking, this is not something you are tentatively suggesting. You are making recommendations that you think have far-reaching consequences. And you are in effect recommending legislation because you are saying they should have AAA rating, and that should be passed as soon as legislation is enacted. In effect, you are making full recommendation that should probably put into legislation——

Mr. GLAUBER. At this time, the administration is not bringing before you a specific recommendation of legislation, per se, but these recommendations contained in this report, you should consider the final product of the report.

Chairman PICKLE. Well, I have to assume they are effective legislative recommendations, assuming this committee follows through, because you are making recommendations and you make reference to the fact they should go into effect as soon as legislation is passed, so I have to assume it is one in the same thing.

Now, let's see what I want to ask you on your statement. Let me go to some of these others here.

How would you say the capitalization of GSE's compares with other financial institutions, at home or abroad?

Mr. GLAUBER. It is difficult to give a single answer to that, Mr. Chairman, because the capitalization varies across these GSE's. To cite two examples, the Federal home loan banks have capital which is roughly 8 percent of their assets, Freddie Mac and Fannie Mae have capital which is about 1 percent or a little less of their assets, prime capital, so they vary a great deal.

It was our conclusion that simply looking at capital adequacy by itself may not be truly revealing of the safety and soundness of the individual institutions, which is why, of course, we proposed a more comprehensive measure of safety and soundness or mechanism for engaging in it.

The answer, though, very simply, sir, is at one extreme, they seem to have considerably less capital than a typical financial institution. In some instances, they seem to have more.

Chairman PICKLE. In your testimony, I gathered rather strongly that these GSE's that we have are some of the most highly leveraged financial institutions in all the world, that they have very little private capital in many of them, and that they are just, in effect, they are all leveraged, rather highly. Is that not basically correct?

Mr. GLAUBER. That certainly is correct, Mr. Chairman. Some of them are very highly leveraged.

Chairman PICKLE. I wonder why, if that is basically a fact, and we have to recognize that, I wonder why Treasury hasn't developed a broad capital adequacy formula to use for the GSE's? Can you tell me why we haven't done that previously?

Mr. GLAUBER. I think there are several reasons. First, Treasury has never interpreted its role as acting as the safety and soundness policemen of these institutions. Treasury has viewed its role traditionally as really auditing their securities, or for sequencing to make sure they don't clog the capital market for sequence.

In regard to capital adequacy provisions, as I suggested in my testimony, I think that might be very difficult for institutions as diverse as these GSE's are.

Chairman PICKLE. Well, in reviewing the GSE's, as they currently operate, are you satisfied their present levels of capitalization are commensurate with the risk involved?

Mr. GLAUBER. I think the answer to that would vary from GSE to GSE. Some of them, I think, should have more capital. Indeed, several of them have announced plans to increase their capital.

Chairman PICKLE. You would recommend some of the GSE's increase their capital, or their reserve. I noticed how 3 or 4 days ago, Fannie Mae announced to our representative that they were increasing their reserves by some $2 billion, and a few minutes ago, Fannie Mae issued a statement saying that they commend you for your testimony, and they are all for these progressive recommendations that you are making.

However, they said that they didn't want to respond to your proposal that private rating agencies evaluate and decide GSE's' finan-

cial soundness. I assume they are not too much in favor of this AAA rating.

That is two instances where Fannie Mae has responded since FIRREA legislation required these studies. Let me go one step further. That Fannie Mae held a press brief this week, said they are going to retain $2.5 billion in earnings by the year 1991, that is over the next 2 years, in order to meet its own internal capital standards. A CBO report shows that as of the end of 1989, Fannie Mae, under its own standards, should have capital reserves of $4.6 billion.

Fannie Mae actually had reserves of only $3.5 billion, and was therefore undercapitalized by $1 billion or 32 percent.

Now, we should give Fannie Mae credit for taking initiative to raise capital, but I think it is significant they have done so. They are either catching up with us or we are catching up with them, but we are all getting caught up, because all at once, they said, we are going to raise capital of $2 billion or more.

I think it is tremendously important and significant they do that, and Mr. Gradison made reference to that general approach.

I think it is important that we do increase the capitalization of some of these GSE's. I don't think it does much good to say meet these stress tests. Fannie Mae said they meet stress tests right now, which is basically their stress tests, based on the facts and figures in the tests they put together. I assume if Treasury ran a test, because I understand you did it—the results might be a little different, assuming one or two factors were changed.

I don't think that is so important now, but the fact is there are these GSE's, they are overleveraged, they are at risk. The Federal Government runs the risk of some $800 billion.

I am going to yield at this point to Mr. McGrath.

Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

Mr. Secretary, I get a little nervous when Government agencies make studies using only the information which is given to them by those being studied.

Are you confident the Treasury Department had access to all the information that the GSE's have in the preparation of this study? Did the Treasury Department have access to the same information on the same terms as the nominal regulators of each GSE have access to?

Mr. GLAUBER. I am confident that we had access to the information we requested, particularly as amended in these couple of cases.

Let me ask Mr. Basham, who handled the day-to-day discussions with the GSE's, to perhaps elaborate on that.

Mr. BASHAM. We made a series of requests starting last fall to all the respective GSE's for certain types of information. And I would say in almost all cases, they were very responsive. Some were not as responsive in terms of getting data to us as quickly as we would have liked, but they assured us they were giving us their best effort, and quite often, we asked for information in a form or format that they did not have it, so it took a while to compile it.

In terms of the accuracy, there were several instances some of the information we were given was recalled, because it was inaccurate, not once, not twice, but several times. That was a little dis-

concerting when that happened, and fortunately it didn't happen a great deal.

I would say in the vast majority of cases, we had the kind of access we hoped to have.

Mr. GLAUBER. Again, if I might add, Mr. McGrath, let me emphasize, as I said in my statement, we did not perform any kind of audit, nor did we view that as our charge.

Mr. MCGRATH. As you have pointed out, we all know most GSE's are regulated for safety and soundness by the same Federal agency which is responsible for its programmatic activities, such as Housing or Agriculture. Your testimony points out that it may be imprudent for that kind of relationship to continue.

Have you found that there is any real danger that the programmatic zeal of an agency might lead it to compromise its regulatory discipline?

Mr. GLAUBER. Well, I think I would relate to you the experience we have had when we looked at the thrift regulation, and there we concluded that there is inherent conflict between the program regulator, whose natural inclination is to sponsor the development of the program, and in the case of the thrift industry, the insuror, whose natural position should be that of a very tough-nosed safety and soundness regulator, and I think that some of the same kinds of inherent conflicts exist with the GSE's, difficult for any regulator to deal with, and we think that in the future, it would just make a great deal more sense to have those two different perspectives vested in the two different entities.

Mr. MCGRATH. Should we decide we are going to separate the programmatic function from the regulatory function, who would conduct the regulatory function?

Mr. GLAUBER. I think there are a number of candidates for the job. I think the Federal Reserve System could do it as a standard safety and soundness regulator. The FDIC was the agency we looked at in the case of the thrift industry. Obviously, the Treasury would be another alternate candidate.

Mr. MCGRATH. What did the study conclude regarding the capital adequacy of each GSE?

Mr. GLAUBER. Well, I think, Mr. McGrath, perhaps it would be better if I allowed you and Congress to read the detailed study itself, rather than try in this forum at this time to go through the details of those conclusions.

Mr. MCGRATH. How could we without given the adequate amount of information, measure the adequacy of the capital requirements?

Mr. GLAUBER. If I may say, it is indeed a very serious problem. I think that at least by our recommendation, that can best be done by somebody experienced in the process of trying to evaluate safety and soundness, measuring COW, which is why we put before you this recommendation to use private sector credit rating agencies.

The problem really is that safety and soundness, or COW, or exposure to risk, depends on a wide variety of factors, of which capital adequacy really is only one. There are issues as well, management capability, operational capability, all the things that we know from the private sector have an important bearing on safety and soundness, and it is for that reason we put forward this process, recommendation, and I think given our views, ultimately we would

like to look to that evaluator for a determination of specific capital adequacy or inadequacies.

Mr. MCGRATH. Given that answer, does the study address the marked-to-market approach for evaluating the financial condition of the GSE?

Mr. GLAUBER. It discusses that. It discusses a number of other——

Mr. MCGRATH. Are there any conclusions?

Mr. GLAUBER. Our general conclusion is that the approach is revealing in some ways, but not one we would rely singly on or say it is applicable to all the GSE's. Again, Mr. McGrath, the general tenor is it would be very difficult to have any single approach work effectively with all these GSE's. The most obvious one would be to use the bank, thrift capitalization.

These are standards that differ one from another. It is hard to have a straitjacket of any single mechanistic approach be meaningful. I know it is a long answer, and not a particularly revealing one, but I think this is a difficult situation where you can't really reach for a simple, straightforward approach to measuring riskiness.

Mr. MCGRATH. Mr. Chairman, this looks like it may be an interesting bill.

Thank you.

Chairman PICKLE. The indication is there may be a bill. Before I recognize Mr. Gradison, Mr. Basham, you said that the GSE's cooperated in the study, but if I understood you correctly, you said that some were not as responsive or as timely, and that several gave the Treasury wrong information, two or three times.

Did I understand you correctly? Which GSE's are you talking about?

Mr. BASHAM. Mr. Chairman, the GSE that was not as responsive as we would have liked it, was Connie Lee. I believe there was some misunderstanding between them and us as to exactly what was the nature and scope of our study, and there was one specific request that was not filled completely. They were under the impression if we didn't ask for specific documents, then they did not have to give them to us.

Chairman PICKLE. And yet, they are one of the least at risk of the GSE's, I presume. Again, that is strange they would be hesitant. Any other GSE's involved?

Mr. BASHAM. I would characterize that probably as a misunderstanding on their part.

Chairman PICKLE. Can you tell us what the issue was?

Mr. BASHAM. With respect to Connie Lee, that was the only issue.

Chairman PICKLE. Connie Lee or any of the GSE's that did not give you timely or correct information.

Mr. BASHAM. That was the only instance where I would consider that they did not cooperate in a timely fashion. There were some instances where we asked for information, data, that was given to us in a timely fashion, but then was recalled because it was inaccurate, and I will attribute that quite often to the nature of our requests.

On some occasions, they didn't have the data as we needed it.

Chairman PICKLE. Thank you.

Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

First of all, Mr. Chairman, I would like to comment as you did on the statements by Fannie Mae. I believe they are fine, as far as they go, but my understanding of what they have said is that these additions to capital which they are talking about are conditioned upon future earnings. I hope it all works out, but if that be the case, I would like to make two points about it.

If this means they hope to earn a lot of money and reinvest it, that suggests to me they aren't necessarily going to do anything in the future any differently than they would have done anyway in order to build up their capital.

The second thing is that unless we know how much they intend to borrow, knowing they are going to add to capital doesn't tell us anything whatsoever. It may mean, at the end of the period, their capital adequacy is stronger or weaker, depending upon the ratios involved. So I look forward to the chance to talk directly with them about it.

I believe so far what they have said is just fine, but at best, it is half the picture.

Mr. Secretary, on the middle of page 3, you said the financial risk inherent in institutions of this size poses a greater systemic risk. What is it about the size?

Mr. GLAUBER. Well, I think it really is the size in conjunction with the lack of diversification that can cause some concerns. These are, as I mentioned in my testimony, institutions which are mandated to hold essentially undiversified portfolios. Diversified in the case of Fannie Mae or Freddie Mac by geography, but undiversified as regards the type of instrument, and that together with their great size is really what I had reference to.

Mr. GRADISON. The reason the size surprised me is I could see an argument on the other side, size would make it easy to diversify.

With regard to your point one, you said that if certain steps were not taken, that there should be an explicit severance of Federal relationship. How do you do that? I mean, we disclaim any guarantee today. If we said tomorrow, we disclaim any guarantee, where is that any different from where we are at the moment? Will people believe us?

Mr. GLAUBER. I don't know the answer to that. Clearly, the market today trades these instruments as if they were better than AAA. I think certain steps could be taken. There is this web of Federal relationship from the charter to the fact most of them don't have to register with the SEC. They are exempt from State and local taxes.

There are a number of relationships which underpin the market's perception of government being ready to step forward. I think those could be removed, presumably Congress could go on record, explicitly, but I accept your statement, Mr. Gradison, that it is unclear what the markets would, in fact, presume.

Mr. GRADISON. One thing that occurred to me, which is very different from what you suggested, would be to have an explicit guarantee for debt which bears a certain relationship to capital and to say anything above that, folks, you are on your own. So when those

lenders come in, it would be like a highly subordinated form of borrowing, and that would be very explicit at the time the new borrowing took place. I hope we never have to reach that point.

With regard to your looking to the credit rating agencies, have you discussed with them whether they would be able to do something like this, that is, to assume something which is not currently the case?

Mr. GLAUBER. We have had informal discussions with them, and our conclusion from those discussions is that they feel that they could put the GSE's in a what-if kind of position.

Mr. GRADISON. What would trigger?

Mr. GLAUBER. Excuse me. They would require, obviously, greater access to information than they currently have, and presumably, they would receive greater access.

Mr. GRADISON. Presumably, they are going to want to get paid for this.

Mr. GLAUBER. Presumably, they would want to get paid for this.

Mr. GRADISON. I don't object to it. I am trying to think through what would we or you have to do the duties involved by whoever is doing this for us?

Mr. GLAUBER. This is a tradition in the private sector of corporations buying this service. When they go to market, they realize in order to market the security successfully, they have to have a rating, and they pay for that. It is not an extraordinarily large amount of money compared to the size of these institutions we are talking about; in the case of the largest one, $300 billion institutions, a cost of $50,000 or $60,000 or $70,000 for such a rating would not be onerous.

Mr. GRADISON. It sounds like a lot less than they have lobbyists to leave them alone.

Mr. Secretary, did I understand you give them up to 5 years to get straightened out on this?

Mr. GLAUBER. That is what we said, although during that period, they would be under a business plan, if you will, that would audit their progress towards that goal.

Mr. GRADISON. Thank you.

Mr. GLAUBER. Clearly, that proposal could be modified in some way.

Mr. GRADISON. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman PICKLE. Well, Mr. Secretary, have you—with respect to the rating of the various GSE's, how do you think Standard & Poor's and Moody's would rate our GSE's?

Mr. GLAUBER. I think they would be the best people to ask that. We understand they are in a difficult position at this point, because they haven't had access to the full range of information to which they would have access were they asked to do this in a formal way. I think at this point, it would be really speculative to say how they would rate them.

Chairman PICKLE. Did you ask management how you would rate GSE's?

Mr. GLAUBER. Not specifically.

Chairman PICKLE. Did Treasury ask Standard & Poor's how they would rate our present GSE's?

Mr. BASHAM. Yes, sir, we did. They gave us an unofficial rating. They were quick to point out though that the information they had is only publicly available information. They asked us to withhold that rating because once they have the chance to look at the detailed information, that might affect the rating itself.

Chairman PICKLE. I understand they have to issue a qualified response because they take the information from the GSA and they would be limited. But it would be less than AAA?

Mr. GLAUBER. Certainly that would be correct, yes.

Mr. BASHAM. Yes.

Chairman PICKLE. I think that is important information. Now, Mr. Gradison has asked what improvements could have been made to address market concerns if we do make these recommendations?

How will the public interpret the changes and would it have any effect? Nobody knows that for certain, I guess. But you also know that you would be making these changes that you would be guaranteeing that somebody does supervise these agencies.

In this case there is no supervision. With respect to Fannie Mae, I don't know who regulates Fannie Mae. Do you?

Mr. GLAUBER. HUD does.

Chairman PICKLE. Well, HUD is supposed to. but if you get the sheriff's posse, you couldn't find that person over there and they, themselves, don't know where to locate them if they are in the building. So you have to assume that there is no regulation on it.

You also have to say that although you are recommending a AAA rating, and right now you feel safe about it, and Fannie Mae is increasing their capital reserve another $2 million, at the same time what would prevent Fannie Mae from coming down and lowering their capital next month if they want to?

Mr. GLAUBER. I understand your point, Mr. Chairman.

Chairman PICKLE. You didn't answer my question. Couldn't Fannie Mae lower their capitalization 6 months from now?

Mr. GLAUBER. They currently operate under it, the debt can hit 20 to 1. There are certain limitations to those standards. They don't include, for example, off balance sheet kind of instruments. So they clearly have a great deal of flexibility within those standards.

Chairman PICKLE. Well, of course.

They use a standard, their own standard or what they call HUD standards. But there is very little supervision. You are recommending that everybody doesn't abide by the same standards; that they are unique and different.

But if we established a regulator for that particular GSE and that is spelled out clearly, then we will know where the responsibility is and there should be no misunderstanding about that.

Mr. GLAUBER. That is right. Furthermore, although we don't recommend a specific mechanism for setting the capital level, we have the mechanism of using a private rating agency to determine the overall number.

Chairman PICKLE. With respect to the GSE's, not every GSE is overseen by a Federal agency responsible for the safety or the soundness of that GSE operation. They are not all regulated or overseen.

Mr. GLAUBER. That is correct.

Chairman PICKLE. You start off at the very beginning. That is one of the first things you should do. If we change the law it would have a very definite effect on the market. So I think that these are certain things to begin with. Mr. McGrath.

Mr. MCGRATH. Thank you. Mr. Secretary, based on your experience with the farm credit crisis and the savings and loan problems, if a GSE were to become insolvent what statutory or regulatory provisions are currently in place to allow for a GSE to be put into conservatorship or receivership as currently occurs with a failed bank or a thrift?

Mr. GLAUBER. I can't answer that question directly. I can tell you that were it in financial straits the Treasury Secretary has the obligation to purchase a certain amount of its securities and of course that is very different from the obligation.

Mr. MCGRATH. Well, then the question of how it would be treated in bankruptcy would likewise be up in the air?

Mr. GLAUBER. I believe the answer to that is, yes, but I think I will have to get back to you with the details of that.

Mr. MCGRATH. Similarly the relative status of creditors and of guaranteed securities would be problematic? Do we have a better answer?

Mr. BASHAM. Counsel has informed us that we are not aware of any special provisions that would apply to the GSE's but we are not absolutely sure. We will get back to you for the record.

Mr. MCGRATH. Thank you, sir.

Chairman PICKLE. Well, Mr. Secretary, first either you or Mr. Basham, under your so-called plan about getting the rating and bringing everybody up to a certain standard, would the existing GSE's have 5 years to get up to snuff; that is, to maintain a AAA rating?

Mr. GLAUBER. That is the quote.

Chairman PICKLE. Would any of them be grandfathered as of this time?

Mr. GLAUBER. The proposal is that they would have 5 years and if they were not necessarily at that level, they would enter into a business plan arrangement.

Chairman PICKLE. If we were to pass this legislation, a GSE would still have 5 years to "climb up to a certain standard?"

Mr. GLAUBER. That is the proposal. Obviously it could be altered in regards to the number of years.

Chairman PICKLE. Well, I don't know that I understand this. It seems to me like the public would think you have 5 years to correct a bad situation and that would be mighty slow corrections.

Mr. GLAUBER. What is envisioned is a step-by-step plan that would move them from where they are to that goal over those 5 years. It would not be a plan where they did nothing for 4 years and then the 5th——

Chairman PICKLE. If they did set that plan in motion and in the whole process of getting all the GSE's up to the standard it should, is there any cost to the Federal Government under your plan?

Mr. GLAUBER. Well, I think under the plan the major benefit to the Federal Government is that it would systematically reduce the risk to which these institutions expose the taxpayer.

Chairman PICKLE. I sense that you are saying there is really no cost involved in making these corrections? And at very little cost, at least you could be making correction to a possible multibillion-dollar disaster at little or no cost?

Mr. GLAUBER. I think the cost would be minimal. There is always going to be a tension between building capital and, for example, supporting the purpose of these GSE's.

But I think this is an appropriate balancing between the two perspectives and the cost would be minimal.

Chairman PICKLE. Let me talk to you about one or two of the agencies we seem to hit on. Fannie Mae, because they are the biggest, based on your experience with the farm credit system and the savings and loan bailout also, problems can more easily arise when the institution has a single program and or financial supervisor.

Can you tell me which GSE's do not have a programmatic supervisor? Which one of them do not have?

Mr. GLAUBER. Two of them don't. Connie Lee does not and Sallie Mae are the two I believe that don't.

Chairman PICKLE. What is the other one?

Mr. GLAUBER. Sallie Mae. Student Loan Marketing Association.

Chairman PICKLE. Well, now what about Fannie Mae and Freddie Mac?

Mr. GLAUBER. Fannie Mae and Freddie Mac have a regulator, HUD, who is responsible both for the program as well as safety and soundness standards. Under the current set up, Mr. Chairman——

Chairman PICKLE. That would be HUD such as it is.

Mr. GLAUBER. That is correct. If I might point out, Fannie Mae has on its own imposed upon themselves higher credit standards than those imposed by HUD. Furthermore from the very beginning of our discussions with them, they have indicated their intention to build capital.

They have publicly announced, I think it is only fair to say that the capital adequacy and financial situation of Fannie Mae today is much better than it was 3 or 5 years ago. I don't think that should be lost.

Chairman PICKLE. We had the difficulty in 1984 with the farm credit system and we pumped $4 billion into the farm credit system. That bottomed out because of world prices, drought, inflation, the price of the American dollar and just bad weather, I guess.

A combination of the Lord blessed us with five different things all happening in a period of time. Now we do have a regulator over the farm credit system, a regulator who is supposed to look at the area. Given that the correction, and attempts to try to prevent this kind of thing, is this same thing able to happen again in the future?

Mr. GLAUBER. I think it is possible. I don't think it is an imminent likelihood.

Chairman PICKLE. No. Even though we do have a regulator, that in itself, unless we have higher capital reserves or some other correction, doesn't give us any assurance but at least it could cut our losses.

Mr. GLAUBER. That is right. Our greatest assurance comes from having high capital reserves and private capital at risk.

Chairman PICKLE. Now on to Fannie Mae and Freddie Mac. Which assumes greater risk to the Government?

Mr. GLAUBER. It is a very complicated situation. I think most analyses would conclude that Fannie Mae's risk is somewhat greater because it has more on the balance sheet.

Chairman PICKLE. It has both portfolio lending and guaranteed mortgage backed securities.

Mr. GLAUBER. They have both but more——

Chairman PICKLE. Well, then why is Freddie Mac very little risk to the Government?

Mr. GLAUBER. They have guaranteed securities, which does not include interest rate risk. It only includes credit risk. Interest rate risk is a very important dimension.

Chairman PICKLE. They don't depend on the fluctuation of interest.

Mr. GLAUBER. That is right.

Chairman PICKLE. Somebody else takes that risk. Freddie Mac is more secure?

Mr. GLAUBER. They only have interest rate risk for the 20 some odd billion dollars worth of securities on its own balance sheet.

Chairman PICKLE. All right now if a GSE were to become insolvent, I hasten to say I don't know any that will become insolvent, but, if so, what statutory or regulatory provisions are currently in place to allow for a GSE to be put into conservatorship or receivership as occurs when a failed bank or thrift institution goes under?

Mr. GLAUBER. We believe that there are special provisions that deal with GSE's, although we would like to research that and get back to you for the record.

Chairman PICKLE. I didn't hear you.

Mr. GLAUBER. We don't believe there are any special provisions.

Chairman PICKLE. If one did become insolvent, there is no statutory regulations. If you went bankrupt there isn't a bankrupt provision that you could appeal to protect you. But if one of the agencies go under, it is left to the Congress totally.

Mr. GLAUBER. As we have discussed the market certainly has some very clear views on how Congress would act?

Chairman PICKLE. That is why there is a potential $800 billion risk out there. We have to be concerned about it as a Congress.

I will repeat just for myself, you don't mind me, but I want to make sure we understand. I think your testimony, recommendations, are strong medicine and good medicine for this republic of ours and we should listen to them and the Congress must be responsive.

You are saying that a GSE should be adequately capitalized with high credit and operational standards, and be subject to effective Government supervision or else Congress should terminate their responsibility. And, second, you say that a private market mechanism should be used to evaluate GSE risks; that you don't let the same person buy and sell, or promote and buy at the same time, because, obviously, there are cross currents of interest there inevitably.

HUD is interested in building homes and providing for housing and your recommendation would not prohibit them from doing that at all. But, they also are not interested in trying to cut down credit and money to build them, because they want that to be done.

Therefore, they are interested in subsidies apparently. They have been interested in financial credits or solvency. Thus, if you separate these functions that would make a good recommendation in my opinion.

Mr. GLAUBER. Mr. Chairman, if I might interrupt, without trying to single out HUD or the Department of Education or the Agricultural Department, our opinion is that to ask the same regulator to do both functions is very difficult. The prospectives are different. Regulating the programmatic and the safeness and soundness is very hard to do. We saw how the problems can arise in the thrift industry when one agency was asked to do both.

Chairman PICKLE. Your recommendation, I say, that was one and——

Mr. GLAUBER. I think you incorporated my second and third recommendation in just what you said.

Chairman PICKLE. Yes. We just finished that one, concerning different regulators, and the last is ensuring that the public knows where the risk actually lies. Now those are strong recommendations and I think that the Congress should listen to what you are saying. We will be interested in your final report.

Let me see if I have any other questions. Mr. Gradison, do you have any other questions?

Mr. GRADISON. No, sir, Mr. Chairman.

Chairman PICKLE. Currently neither the administration's budget nor any other budget document prepared by the Government or Congress reflects any cost associated with GSE operation. Now should the GSE subsidy expenditure be counted for in a manner similar to other Federal spending, such as indirect spending as with tax expenditures? Do you get my question?

Mr. GLAUBER. I do. Our recommendation is not that it should be accounted for that way, but it should be revealed, put on the record so that there can be a sense of what would be the subsidy in terms of the interest rate.

I might add there are other benefits.

Chairman PICKLE. Should these GSE's register their securities with the SEC?

Should they list what their investments actually are?

Mr. GLAUBER. They are not regulated. They do not have to register with the SEC with the exception of Farmer Mac and one other.

Chairman PICKLE. Do any of them register now?

Mr. GLAUBER. Farmer Mac is registered with the SEC. Just Farmer Mac.

Chairman PICKLE. I wonder why they do?

Mr. GLAUBER. In general the view is that these institutions are of such low risk that SEC registration is just not necessary.

Chairman PICKLE. Well that would be interesting to see how that comes out. Now, Mr. Secretary, I am glad to have your four principal recommendations and although you don't specifically recommend them as items for legislation, of course that has to follow, if

we find that there is some validity to each one of the recommendations as their obviously is.

Fortunately at this time and hour none of the GSE's are going belly up to our knowledge. The public should not be frightened. But the public should be concerned about the risk involved. That is why we put this resolution in and we will ask you to follow through.

You have given us good recommendations and I think the Congress will also followthrough. We will be interested in getting the final report. I would hope, Mr. Secretary, that you stand fast with your recommended principles; that we don't go into the GSE issue only to holler wolf, or lobby that this or that should not be done.

I assume that that will not be done. And then the Congress will take a look as we go forward. We will have another hearing on this after we have gotten your final report. We will know where we stand on it. So I want to thank you.

If any other members have any other questions? Well, I thank you very much, Mr. Secretary, for your testimony.

Now the next witness will be the GAO. We have also asked them to look into this question. We will be glad to have their report now.

Will Mr. Richard Fogel, Assistant Comptroller of GAO come forward.

Our next witness will be Mr. Richard Fogel, the Assistant Comptroller General of the GAO.

Mr. Fogel, will you identify the individuals at the table with you.

STATEMENT OF RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT PROGRAMS, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY CRAIG SIMMONS, DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES, AND SUZANNE McCRORY, ASSISTANT DIRECTOR, GENERAL GOVERNMENT DIVISION

Mr. FOGEL. Thank you very much. On my right is Craig Simmons, Director of all our financial institutions work with GAO, and to my left, Suzanne McCrory, the Project Director on our GSE work.

Chairman PICKLE. Glad to have you here.

Mr. FOGEL. Thank you.

I would like to ask my full statement be entered into the record, and I would like to summarize it. We are pleased to be here today to discuss our preliminary findings on GSE's.

Given their public policy links to the Government, a GSE experiencing serious financial difficulties could pose expensive decisions for the Congress, like those it faced during the farm credit and thrift crises.

No one wants to see those experiences repeated. Now, I would like to discuss the four risks FIRREA asked us to study. Interest rate risk, which is the possibility——

Chairman PICKLE. Mr. Fogel, before you race through this item, we have plenty of time. Just above that on table one you talk about the GSE that you studied. You have farm credit banks, banks for cooperatives and Federal home loan banks. I guess you are saying

that those three are all portfolio lenders and that they are more risky than the others.

Is that a sensible way to phrase it?

Mr. FOGEL. That is essentially correct. As the chart shows, you can classify GSE's as either portfolio lenders or guarantors. As you can see, two of the GSE's do both: Freddie Mac and Fannie Mae. The others are either portfolio lenders or guarantors.

Generally portfolio lenders are exposed to interest rate risks which makes them more risky than those with just the other types of risks.

Chairman PICKLE. As I look at these, Fannie Mae, they are both portfolio lenders and a guarantor. About a third of it as lender and about two-thirds of it as guarantor. So they change the figure some. Freddie Mac would also be both lender and guarantor, but a very small percent of it is to lenders and a high percent of it as guarantor.

So that would be why Freddie Mac would be less risky than some of the others?

Mr. FOGEL. That is correct.

Chairman PICKLE. All right, go ahead.

Mr. FOGEL. As I said, GSE's operate as portfolio lenders and have a greater exposure to interest rate risk than those who operate strictly as guarantors.

The second type of risk, which applies to all GSE's is credit risk. That is the possibility of losses from borrowers failing to repay their loans or other parties like mortgage insurers failing to honor claims.

The third is business risk, which is a possibility of losses from factors largely beyond the GSE's control such as crop failures, droughts or new legal requirements that may alter the way they do business.

The fourth type of risk is management and operations risk, which is the possibility of losses resulting from poor decisions or indecisiveness on the part of GSE's management.

GSE's deal with these risks in the normal course of business and use their existing capital to cover any losses they may incur. If the losses exceed available capital, the GSE could fail, thereby posing a problem for the Government.

Our preliminary work suggests that no GSE is currently in danger of immediate failure. I will briefly describe each GSE's current risk exposure and its related control mechanisms:

From a consolidated perspective, the farm credit system of farm credit banks, banks for cooperatives, and their related associations were able to report profits in 1988 and 1989 after 3 years of losses caused by serious agricultural recession and resulting loan defaults, high exposure to interest rate risk, and management weaknesses.

Most of these profits have resulted from reversing loss reserves taken in prior years. The Agricultural Credit Act of 1987 provided system institutions up to $4 billion in Federal assistance which has alleviated any immediate concerns about system viability.

However, system institutions report that loan repayment is questionable for about 14 percent of their $49 billion in loans outstanding at the end of 1989. In addition, the Farm Credit Administration

has identified weaknesses in the management of institutions that hold over 60 percent of the system's assets.

Furthermore, the system's health depends heavily on the general state of agriculture. Farm credit institutions have recently developed systems that should enable them to better control their interest rate risk. In addition, new risk-based capital requirements are being phased in——

Chairman PICKLE. Let me interrupt you there because you have my attention when you said the—it is questionable for about 14 percent of their $45 billion in loans outstanding as of 1989. Now 14 percent would be $7 or $8 billion.

Mr. FOGEL. That is correct.

Chairman PICKLE. Does that mean that we might fall behind or go in a hole for that much during this next year, this $49 billion?

Mr. SIMMONS. Not necessarily. There is collateral backing most of these loans—it could be for land or housing or crops. If these loans do go bad, they can be restructured or the collateral can be sold off.

You will get more than no cents on the dollar so it would be less than that.

Chairman PICKLE. Well, our own report said the repayment is questionable. So you have—you are saying to me it is a possibility, a definite possibility. Is that correct?

Mr. FOGEL. It is a possibility, not a probability. but we are not——

Chairman PICKLE. I understand.

Mr. FOGEL. We are not totally sanguine about the health of the farm credit system today.

Chairman PICKLE. What do you mean when you say the Farm Credit Administration has identified weaknesses in management of institutions that hold over 60 percent of the system's assets?

Mr. FOGEL. The regulator in this case, the Farm Credit Administration has been looking at farm credit banks and is concerned about how they are operating. Their auditors and examiners have been in these banks and have identified specific actions that they want these banks to take to get their operations in better shape.

Chairman PICKLE. What can we expect will happen from a timing standpoint?

Will we get another report on that in 60, 90 days?

Mr. FOGEL. We have to talk to the Farm Credit Administration. We can certainly follow up.

Chairman PICKLE. I would ask you to do that at some appropriate time, give us a further analysis of that mismanagement if there is or questionable mismanagement.

Mr. FOGEL. We would be glad to do that.

The Federal home loan banks have historically presented little risk of failure. Their conservative lending policies provide a substantial cushion for losses. Future profitability, however, will be dampened because part of the Federal home loan banks' earnings will be used to help pay the costs of thrift failures and to fund new affordable housing programs.

Chairman PICKLE. Well, now Mr. Fogel, I hate to interrupt you, but as you make these points it seems the time to do it. Funds from the home loan bank are now being applied to the RTC operation.

We have done so because, one, they have money and, second, they can do it on their own, off-budget.

Now that we have taken that action, does that mean that we have weakened the Federal home loan bank system that could cause problems later?

Mr. FOGEL. I don't believe that it has weakened the home loan bank. I think it was absolutely appropriate to require that they finance part of the bailout for the thrift industry because some of the banks were part of the problem getting us into that condition. But what it will do is reduce some of the earnings flow.

But they still have high capital requirements and they are very conservative in how they lend in terms of the collateral that they demand. We think they are still safe and sound.

Chairman PICKLE. Go ahead.

Mr. FOGEL. Fannie Mae faced financial troubles serious enough to result in losses for 4 years in the early 1980's. Legislation was enacted in 1982 that lengthened Fannie Mae's tax loss carryback period, qualifying it for refunds that a Fannie Mae official estimated to be $25 million.

Fannie Mae was able to recover from its problems and posted record profits in 1989. Its financial difficulties resulted primarily from interest rate changes. Fannie Mae reports that its exposure to interest rate risk has been greatly lessened although not eliminated.

Its losses from credit risk have also declined from unusually high levels experienced in the mid-1980's. Fannie Mae is rebuilding its capital base and has recently announced the planned addition of $2 billion in capital. It plans to hold capital sufficient to withstand, on a national basis, its default experience from mortgages originated in Texas in 1981 and 1982.

Freddie Mac has consistently reported profitable operations. Freddie Mac generally avoids interest rate risk by limiting its portfolio lending, preferring instead to create mortgage-backed securities that pass interest rate risk on to the security investor.

Freddie Mac's credit losses from its guarantees have been generally lower than industry averages. Freddie Mac's policy is to hold capital sufficient to absorb, for a period of at least 7 years, the effects of housing defaults comparable to those experienced during the Great Depression. Currently, Freddie Mac says it holds sufficient capital to withstand such losses for 10.5 years.

Sallie Mae's financial performance has been consistently profitable. Because student loans are guaranteed by State agencies and the Federal Government, it has experienced minimal credit losses.

Its policy is to minimize losses from changes in interest rates by borrowing funds with interest rate payments that adjust parallel with the interest it earns on its student loans.

Sallie Mae has decreased its capital holdings since 1984 from about 5 percent of assets to about 3 percent in 1989.

Connie Lee expects little or no losses from credit risk and is not exposed to interest rate risk in its current business of bond reinsurance. Connie Lee's capital is set by management to conform to private market standards for the highest quality bond insurers.

Farmer Mac has prepared credit standards and methods of operations but has not yet guaranteed any securities.

The day-to-day management and control of risk-taking is largely controlled by GSE managers and owners. For some GSE's, the Government protects its interest by monitoring GSE risk-taking, setting minimum capital levels, and exercising enforcement authorities to prevent GSE's from continuing practices thought to be unsafe.

But for other GSE's, the Government does very little to learn about unnecessary risks and guard against them. Let me briefly describe how the Government oversees GSE risk-taking and capital.

The farm credit system and Freddie Mac are overseen by an independent Federal regulator, the Farm Credit Administration. The Farm Credit Administration has established risk-based capital rules, modeled after those applicable to commercial banks, for Farm Credit banks and banks for cooperatives.

It also examines Bank operations annually and has a full range of enforcement authorities to stop system institutions from engaging in highly risky practices.

The Federal Housing Finance Board regulates the Federal home loan banks. It was created in August 1989 with authority to monitor the risk-taking of banks and enforce safe practices. To date, however, no board members had been appointed and the Secretary of the Department of Housing and Urban Development (HUD) serves with the full power of the Board of Directors.

Currently, it is unclear how effective the Federal Housing Finance Board will be as an independent regulator for safety and soundness.

Chairman PICKLE. Mr. Fogel, the Federal Housing Board regulates the home loan bank, and it was created last year to monitor the risk taking of banks.

You say no board members have been appointed. Why not?

Mr. FOGEL. I think you would have to ask the President and Secretary of Housing and Urban Development why that hasn't taken place. There are several that have been nominated, but I don't know why they haven't acted quicker.

Chairman PICKLE. That was 6, 8 months ago, and no members of that board have been appointed.

Mr. FOGEL. That is correct.

Chairman PICKLE. That is additional evidence of the strong regulatory practices of HUD.

Mr. FOGEL. You could reach that conclusion.

Chairman PICKLE. And HUD also regulates Fannie Mae?

Mr. FOGEL. Oh, yes.

Fannie Mae is subject to oversight by HUD. In August of 1989, HUD also received authority to oversee Freddie Mac when the Federal Home Loan Bank Board—Freddie Mac's former Board of Directors—was abolished.

HUD does not have the full range of explicit enforcement authorities typically available to bank regulators and has never used the audit authority it has to oversee Fannie Mae.

In doing research for our GSE report, Mr. Chairman, we came across a report we issued in April of 1985 criticizing HUD's oversight and regulation of Fannie Mae. In that 1985 report, we said that HUD had disbanded its Fannie Mae Oversight Unit in 1981. It never exercised its audit authority. It has not analyzed the finan-

cial risk of Fannie Mae and that Fannie Mae imposed upon the Government.

It had not studied how well Fannie Mae serves its Federal policy role and that it failed to submit required reports on Fannie Mae's activities.

We made a series of recommendations in 1985 to get HUD to correct this problem. Generally, we don't think they have been as responsive as they should have been to the recommendations we made in 1985.

Chairman PICKLE. Will you submit to our committee a copy of that 1985 report?

Mr. FOGEL. We would be pleased to do that.

[The subcommittee received the report entitled, "The Federal National Mortgage Association in a Changing Economic Environment," April 15, 1985.]

Chairman PICKLE. You are saying nothing changed since then?

Mr. FOGEL. Some things have changed. You have a new Secretary with a little different approach at HUD. But, we still have concerns about the capacity to regulate for the safety and soundness standpoint.

Furthermore, HUD officials told us, and we agree, that it is unclear whether HUD has authority to establish risk-based capital standards for Fannie Mae and Freddie Mac. They do, however, have the authority to require less capital than the statutory debt-to-capital formula specifies.

The statutory debt-to-capital standards currently applied to Fannie Mae and Freddie Mac are not based on the risks they undertake. As table 1 noted, Fannie Mae and Freddie Mac operate both as portfolio lenders and as guarantors. The debt-to-capital standard requires that capital be held for borrowings they make as portfolio lenders.

The standard does not require capital to be held on their guarantees of $500 billion in mortgage-backed securities. Furthermore, although their portfolio lending operations expose them to interest rate risk, the standard does not require capital for such risks.

We are also concerned with the fact that the statutory capital standard is broadly defined to include owner equity, loss reserves, and subordinated debts equally. From the Government's perspective, owner equity represents the best protection to the Government against unexpected losses because owners have incentives to protect their personal investment from losses.

By contrast, loss reserves account for expected defaults and subordinated debt involves borrowings from creditors that must be repaid to avoid default. In the final analysis, Fannie Mae and Freddie Mac can increase their risks without a commensurate increase in equity capital.

HUD officials say that in the future they plan to strengthen their monitoring and oversight of Fannie Mae and Freddie Mac. Nevertheless, we are concerned about inherent conflicts between HUD's housing policy goals and its goals as a financial regulator.

Recent history with the thrift crisis and the farm credit crisis has illustrated the disastrous effects of having regulators both promote the industry and be responsible for financial oversight.

Sallie Mae is not routinely overseen by any Federal agency nor is it subject to federally established capital rules.

Connie Lee, like other insurers, is subject to State regulation that oversees its risk-taking and capital levels.

The sheer size of GSE's financial obligations—over $800 billion, their public policy purposes, and the probability, in view of the precedents of farm credit and Fannie Mae, that the Federal Government would assist a financially troubled GSE, make it appropriate for the Government to oversee their risk-taking activities and establish appropriate capital levels.

The situation that we found is that the Government oversees some GSE's but not others. The agricultural enterprises and the Federal home loan banks each have a regulator with certain authorities to monitor risk-taking and set capital rules.

Connie Lee's activities, like those of other private insurers, are regulated by State authorities and also appear to be disciplined by private creditors. However, Fannie Mae's, Freddie Mac's, and Sallie Mae's risk-taking and capital levels are not closely overseen by the Government.

Furthermore, GSE ties with the Government have weakened the discipline that creditors normally provide to completely private financial firms because these ties provide investors with a reasonable assurance that their claims will be honored by the Federal Government should a GSE fail.

With inadequate Federal oversight and weakened private market discipline, GSE risk-taking and capital are largely controlled by owners and managers.

In financially troubled times after capital is depleted, owners and managers may have incentives to take unusual risks in a last-ditch effort to recover. General creditors may be willing to lend GSE's the funds needed to take these unusual risks if they expect to be protected from loss by Federal assistance.

The farm credit and thrift crises vividly demonstrate the effects of inadequate Federal oversight of the risk-taking and capital of financial institutions. The Government did not have adequate monitoring capability or any capital rules in place to learn about the farm credit crisis in time to prevent it from becoming serious.

For thrifts, capital regulations were largely unenforced and oversight and supervision were weak. As a result, the crisis reached unprecedented proportions. After each financial crisis, legislation reformed and strengthened the supervisory role of the financial regulators, making them more independent and giving them responsibilities for establishing risk-based capital rules. But the regulatory reforms were enacted too late to avoid large taxpayer losses.

While we did not become aware of anything in our preliminary review to suggest that any GSE is in danger of immediate failure, prudence dictates that the Government not wait for a crisis before protecting its interests. By strengthening oversight and establishing risk-based capital rules in the current favorable environment, the potential for future financial crises can be reduced.

We think a better system of monitoring, some reasonable capital rules and appropriate enforcement authorities are needed for Fannie Mae, Freddie Mac, and Sallie Mae. In general, this system needs to assure that the Federal Government obtains timely infor-

mation on the risks undertaken by certain GSE's as well as proper oversight, including congressional oversight.

This oversight should be designed to keep emerging problems from imposing losses on taxpayers and develop appropriate responses quickly so that major unanticipated losses can be contained.

We have not yet formed an opinion on the precise way this can best be accomplished. We plan to continue our analysis and make recommendations in this regard in our final 1991 report.

That concludes our statement, Mr. Chairman.

[The statement of Richard L. Fogel follows:]

STATEMENT OF RICHARD L. FOGEL
ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT PROGRAMS
U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our preliminary findings on government-sponsored enterprises (GSE). We share your concern about the safety and soundness of GSEs. They are very large financial organizations, established by Congress, that undertake a variety of risks to accomplish certain public policy purposes. Their operations have become critical to the finance of housing, agricultural, and student lending. The securities GSEs issue are perceived by investors to have safety comparable to U.S. Treasury securities. Given their public policy links to the government, a GSE experiencing serious financial difficulties could pose tough and possibly expensive decisions for the Congress, like those it faced during the Farm Credit and thrift crises. No one wants to see those experiences repeated.

Our preliminary work on GSEs has involved learning about their operations, the risks they face, and how they measure and control risks. We have also examined how they might transmit the risks they take to the government. My testimony today will describe the purpose and general activities of GSEs, the risks they bear, and how they are regulated. I will then discuss our concerns about the need for appropriate oversight and capital standards for GSEs.

GSEs--WHO THEY ARE, THE RISKS THEY BEAR, AND HOW THEY ARE OVERSEEN

GSEs were created by Congress to correct certain flaws in our financial system that made it difficult for creditworthy borrowers to finance homes, agricultural businesses, or college educations.

One major credit problem that GSEs were designed to solve was the uneven availability of credit throughout the country. When banks depended primarily on local deposits for their lending, creditworthy borrowers living in areas of rapid economic growth had trouble borrowing money when the local deposit base was insufficient to meet the lending demands. The national credit markets that GSEs created have helped to solve this problem.

Another problem that GSEs were designed to solve was the difficulty in attracting large-scale investment funds to agricultural, housing, or student lending. Large-scale investors tended to prefer investments in large denominations that could be easily converted into cash. However, mortgage, agriculture, and student loans tended to be small and could not easily be traded. Furthermore, the risks involved in such lending activities were hard to assess because lending practices varied throughout the country, the loan payments could be unpredictable, and the collection procedures could be difficult. GSEs overcame these problems by offering securities attractive to large-scale investors and, in turn, making these investor funds available to local lenders who want to make mortgage, agricultural, or student loans.

GSEs can be grouped in a variety of ways. One way of grouping them is by their market sector--that is, agriculture, housing, or higher education lending. These market distinctions are important because the general economic climate of the market sector in which GSEs lend typically affects their financial health. Another grouping is by their operating style--portfolio lenders (which hold loans), guarantors, or those that use both techniques. Portfolio lenders borrow money at one rate and lend it at another. They can be vulnerable both to loan defaults and changes in interest rates. By contrast, guarantors enhance the credit quality of financial products for a fee. They are less vulnerable to changes in interest rates than portfolio lenders but equally vulnerable to loan defaults. Table 1 lists the GSEs that we studied, the year(s) each was created, its market sector, and its style of operations.

Table 1:

GSEs INCLUDED IN THIS STUDY

GSE Name	Year Created	Market Sector	Style of Operation
Farm Credit Banks	1916/ 1988	Agriculture	Portfolio lender
Banks for Cooperatives	1933	Agriculture	Portfolio lender
Federal Home Loan Banks	1932	Housing	Portfolio lender
Federal National Mortgage Association (Fannie Mae)	1938/ 1968	Housing	Portfolio lender and guarantor
Federal Home Loan Mortgage Corporation (Freddie Mac)	1970	Housing	Portfolio lender and guarantor
Student Loan Marketing Association (Sallie Mae)	1972	Education	Portfolio lender
College Construction Loan Insurance Association (Connie Lee)	1986	Education	Guarantor
Federal Agricultural Mortgage Corporation (Farmer Mac)	1988	Agricultural Real Estate	Guarantor

GSE Risk Exposure and Control Mechanisms

The Financial Institutions Reform, Recovery and Enforcement Act required that we study four types of risks to which GSEs are exposed:

-- Interest rate risk is the possibility of losses from changes in interest rates. GSEs that operate as portfolio lenders have a greater potential exposure to interest rate risk than GSEs that operate strictly as guarantors.

-- Credit risk is the possibility of losses from borrowers failing to repay their loans or other parties, like mortgage insurers, failing to honor claims.

-- Business risk is the possibility of losses from factors largely beyond the GSEs' control, such as crop failures from droughts or new legal requirements that may alter the way a GSE does business.

-- Management and operations risk is the possibility of losses resulting from poor decisions or indecisiveness on the part of a GSE's managers.

GSEs deal with these risks in the normal course of business and use their existing capital to cover any losses they may incur. If the losses exceed available capital, the GSE could fail, thereby posing a problem for the government.

Our preliminary work suggests that no GSE is currently in danger of immediate failure. I will briefly describe each GSE's current risk exposure and its related control mechanisms:

-- From a consolidated perspective, the Farm Credit System of Farm Credit Banks, Banks for Cooperatives, and their related

associations were able to report profits in 1988 and 1989 after 3 years of losses caused by a serious agricultural recession and resulting loan defaults, high exposure to interest rate risk, and management weaknesses. Most of these profits have resulted from reversing loss reserves taken in prior years. The Agricultural Credit Act of 1987 provided System institutions up to $4 billion in federal assistance which has alleviated any immediate concerns about System viability. However, System institutions report that loan repayment is questionable for about 14 percent of their $49 billion in loans outstanding at the end of 1989. In addition, the Farm Credit Administration has identified weaknesses in the management of institutions that hold over 60 percent of the System's assets. Furthermore, the System's health depends heavily on the general state of agriculture. Farm Credit institutions have recently developed systems that should enable them to better control their interest rate risk. In addition, new risk-based capital requirements are being phased-in that are somewhat analogous to those being implemented in the banking and thrift industries.

-- The Federal Home Loan Banks have historically presented little risk of failure. Their conservative lending policies provide a substantial cushion for losses. Future profitability, however, will be dampened because part of the Federal Home Loan Banks' earnings will be used to help pay the costs of thrift failures and to fund new affordable housing programs.

-- Fannie Mae faced financial troubles serious enough to result in losses for 4 years in the early 1980s. Legislation was enacted in 1982 that lengthened Fannie Mae's tax loss carryback, qualifying it for refunds that a Fannie Mae official estimated to be $25 million. Fannie Mae was able to recover from its problems and posted record profits in 1989. Its financial difficulties resulted primarily from interest rate changes. Fannie Mae reports that its exposure to interest rate risk has been greatly lessened although not eliminated. Its losses from credit risk have also declined from unusually high levels experienced in the mid-1980s. Fannie Mae is rebuilding its capital base and has recently announced the planned addition of $2 billion in capital. It plans to hold capital sufficient to withstand, on a national basis, its default experience from mortgages originated in Texas in 1981 and 1982.

-- Freddie Mac has consistently reported profitable operations. Freddie Mac generally avoids interest rate risk by limiting its portfolio lending, preferring instead to create mortgage-backed securities that pass interest rate risk on to the security investor. Freddie Mac's credit losses from its guarantees have been generally lower than industry averages. Freddie Mac's policy is to hold capital sufficient to absorb, for a period of at least 7 years, the effects of housing defaults comparable to those experienced during the Great Depression. Currently, Freddie Mac says it holds sufficient capital to withstand such losses for 10.5 years.

-- Sallie Mae's financial performance has been consistently profitable. Because student loans are guaranteed by state agencies and the federal government, it has experienced minimal credit losses. Its policy is to minimize losses from changes in interest rates by borrowing funds with interest rate payments that adjust parallel with the interest it earns on its student loans. Sallie Mae has decreased its capital holdings since 1984 from about 5 percent of assets to about 3 percent in 1989.

-- Connie Lee expects little or no losses from credit risk and is not exposed to interest rate risk in its current business of bond reinsurance. Connie Lee's capital is set by management

to conform to private market standards for the highest quality bond insurers.

-- Farmer Mac has prepared credit standards and methods of operations but has not yet guaranteed any securities.

Government's Oversight Approaches Vary

The day-to-day management and control of risk-taking is largely controlled by GSE managers and owners. For some GSEs, the government protects its interest by monitoring GSE risk-taking, setting minimum capital levels, and exercising enforcement authorities to prevent GSEs from continuing practices thought to be unsafe. But for other GSEs, the government does very little to learn about unnecessary risks and guard against them. Let me briefly describe how the government oversees GSE risk-taking and capital.

-- The Farm Credit System and Farmer Mac are overseen by an independent federal regulator, the Farm Credit Administration. The Farm Credit Administration has established risk-based capital rules, modeled after those applicable to commercial banks, for Farm Credit Banks and Banks for Cooperatives. It also examines Bank operations annually, and has a full range of enforcement authorities to stop System institutions from engaging in highly risky practices.

-- The Federal Housing Finance Board regulates the Federal Home Loan Banks. It was created in August 1989 with authority to monitor the risk-taking of Banks and enforce safe practices. To date, however, no board members had been appointed and the Secretary of the Department of Housing and Urban Development (HUD) serves with the full power of the Board of Directors. Currently, it is unclear how effective the Federal Housing Finance Board will be as an independent regulator for safety and soundness.

-- Fannie Mae is subject to oversight by HUD. In August of 1989, HUD also received authority to oversee Freddie Mac when the Federal Home Loan Bank Board (Freddie Mac's former Board of Directors) was abolished. HUD does not have the full range of explicit enforcement authorities typically available to bank regulators and has never used the audit authority it has to oversee Fannie Mae. Furthermore, HUD officials told us, and we agree, that it is unclear whether HUD has authority to establish risk-based capital standards for Fannie Mae and Freddie Mac. They do, however, have the authority to require less capital than the statutory debt-to-capital formula specifies.

The statutory debt-to-capital standards currently applied to Fannie Mae and Freddie Mac are not based on the risks they undertake. As Table 1 noted, Fannie Mae and Freddie Mac operate both as portfolio lenders and as guarantors. The debt-to-capital standard requires that capital be held for borrowings they make as portfolio lenders. The standard does not require capital to be held on their guarantees of $500 billion in mortgage-backed securities. Furthermore, although their portfolio lending operations expose them to interest rate risk, the standard does not require capital for such risks.

We are also concerned with the fact that the statutory capital standard is broadly defined to include owner equity, loss reserves, and subordinated debt equally. From the government's perspective, owner equity represents the best protection to the government against unexpected losses because owners have incentives to protect their personal investment from losses. By contrast, loss reserves account for expected

defaults and subordinated debt involves borrowings from creditors that must be repaid to avoid default. In the final analysis, Fannie Mae and Freddie Mac can increase their risks without a commensurate increase in equity capital.

HUD officials say that in the future they plan to strengthen their monitoring and oversight of Fannie Mae and Freddie Mac. Nevertheless, we are concerned about inherent conflicts between HUD's housing policy goals and its goals as a financial regulator. Recent history with the thrift crisis and the Farm Credit crisis has illustrated the disastrous effects of having regulators both promote the industry and be responsible for financial oversight.

-- Sallie Mae is not routinely overseen by any federal agency nor is it subject to federally established capital rules.

-- Connie Lee, like other insurers, is subject to state regulation that oversees its risk-taking and capital levels.

THE GOVERNMENT NEEDS TO IMPROVE ITS APPROACH FOR OVERSEEING CERTAIN GSEs

The sheer size of GSEs' financial obligations--over $800 billion--their public policy purposes, and the probability--in view of the precedents of Farm Credit and Fannie Mae--that the federal government would assist a financially troubled GSE, make it appropriate for the government to oversee their risk-taking activities and establish appropriate capital levels.

The situation that we found is that the government oversees some GSEs but not others. The agricultural enterprises and the Federal Home Loan Banks each have a regulator with certain authorities to monitor risk-taking and set capital rules. Connie Lee's activities, like those of other private insurers, are regulated by state authorities and also appear to be disciplined by private creditors. However, Fannie Mae's, Freddie Mac's, and Sallie Mae's risk-taking and capital levels are not closely overseen by the government. Furthermore, GSE ties with the government have weakened the discipline that creditors normally provide to completely private financial firms because these ties provide investors with a reasonable assurance that their claims will be honored by the federal government should a GSE fail.

With inadequate federal oversight and weakened private market discipline, GSE risk-taking and capital are largely controlled by owners and managers. In financially troubled times after capital is depleted, owners and managers may have incentives to take unusual risks in a last-ditch effort to recover. General creditors may be willing to lend GSEs the funds needed to take these unusual risks if they expect to be protected from loss by federal assistance.

The Farm Credit and thrift crises vividly demonstrate the effects of inadequate federal oversight of the risk-taking and capital of financial institutions. The government did not have adequate monitoring capability or any capital rules in place to learn about the Farm Credit crisis in time to prevent it from becoming serious. For thrifts, capital regulations were largely unenforced, and oversight and supervision were weak. As a result, the crisis reached unprecedented proportions. After each financial crisis, legislation reformed and strengthened the supervisory role of the financial regulators, making them more independent and giving them responsibilities for establishing risk-based capital rules. But the regulatory reforms were enacted too late to avoid large taxpayer losses.

While we did not become aware of anything in our preliminary review to suggest that any GSE is in danger of immediate failure, prudence dictates that the government not wait for a crisis

before protecting its interests. By strengthening oversight and establishing risk-based capital rules in the current favorable environment, the potential for future financial crises can be reduced.

We think a better system of monitoring, some reasonable capital rules, and appropriate enforcement authorities are needed for Fannie Mae, Freddie Mac, and Sallie Mae. In general, this system needs to assure that the federal government obtains timely information on the risks undertaken by certain GSEs as well as proper oversight, including congressional oversight. This oversight should be designed to keep emerging problems from imposing losses on taxpayers and develop appropriate responses quickly so that major unanticipated losses can be contained. We have not yet formed an opinion on the precise way this can best be accomplished. We plan to continue our analysis and make recommendations in this regard in our final 1991 report.

That concludes my prepared statement. My colleagues and I would be pleased to answer any questions.

Chairman PICKLE. Well, Mr. Fogel, when you said you have not yet formed an opinion on the precise way that this can be accomplished, I would ask you what do you think about the recommendations made by the Treasury just a few minutes ago?

Mr. FOGEL. Well, we think there are a lot of positive things in those recommendations. There are some things we are concerned about, but we think it is very positive that Treasury recognizes that there needs to be capital requirements, that there needs to be a safety and soundness regulator that is separate from the program regulator.

The one area that we want to give some more thought to is a little bit is a total reliance on the rating agencies to regulate the GSE's.

My personal opinion is that it is appropriate to use the private sector to do that if they know about it. But the Government, to protect its interest, must understand the assumptions that are used, must understand how those decisions are made by the rating agencies and must reach an independent conclusion that it believes that the ratings given by the private sector are adequate.

I don't think it is adequate just for the Government to rely on the private sector because we have a very substantial interest in the safety and soundness of these GSE's.

Chairman PICKLE. I don't know that we relied totally on them, but it would be a rating.

Who would regulate or who would give them a rating?

Mr. FOGEL. Well, I don't think that I have a problem with saying that you would have a private sector do the rating. What we want to see is that the Federal supervisor at least know how it was done, understand the assumptions, if you will, go in and audit the rating to make sure that we are comfortable with the rating that was given.

Chairman PICKLE. Well, we have these agencies established to do just that, to give them a rating. The Secretary of Treasury, the Assistant Secretary a few minutes ago said that, if they were rated by Standard & Poor's and Moody's that some present GSE would receive less than a AAA rating.

Why isn't the public entitled to know if they do have a AAA rating, at least know that?

Mr. FOGEL. I think the public should know that.

Chairman PICKLE. You don't object to that?

Mr. FOGEL. No.

Chairman PICKLE. State again why you have a problem in this area.

Mr. FOGEL. My problem has to do not with relying on the private rating firms to do the rating, but what I would like to see is that the Government supervisor, if you will, understand how those ratings are done and be able to assure itself that it is comfortable with the approach and methodology and formulas that the rating agency uses.

Chairman PICKLE. Well, your concern is how it is done and how it is carried out and not the result?

Mr. FOGEL. That is right. I don't have a problem with the results of having the rating agency rate the GSE's. But I would also point out, as I believe Mr. Glauber said, in addition to the rating for, let's

say, interest rate or credit risk, there are other risks that you also want to take into account.

The management of the operation and their business risks, too.

Chairman PICKLE. Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

I think this discussion is getting close to the edge of an issue which we haven't talked much about this afternoon, and maybe we shouldn't. But it is the question of what is the public purpose served by each of these entities and what is the potential public cost of achieving those public goals?

Now that isn't really for us in this committee to determine, and I understand that. But it does lead me to this question, Mr. Fogel: From what you have seen so far in particular with regard to Fannie Mae and Freddie Mac, have we developed a sufficiently mature private secondary market mechanism in this country, or are we close enough to achieving one to be able at least to explore the possibility that maybe we don't need a GSE for those purposes any more?

Mr. SIMMONS. That question was outside the scope of our study, but let me try to respond.

Mr. GRADISON. Ours, too.

Mr. SIMMONS. I think that we may have reached that point. I think the difficulty comes in deciding what to do about it. I mean, how do you unwind 500 or 600 billion dollars' worth of debt that these GSE's do and all the apparatus that is associated with it and assure that the private sector is picking that up as it happens?

When I think about that, I worry very much about the transition you have to make to get it out back into the private sector. Indeed, what you might create, another large private sector institution that would take the place of one of the GSE's that you are trying to supplant in the market. In this case you may still have the Government exposed to the same kinds of risks they are exposed to now.

It is a difficult question.

Mr. GRADISON. I realize that, and I acknowledge, and I mean this sincerely, we should not overstep our jurisdiction in this committee. The existence of these GSE's is a given, and our question is how to protect the Treasury, particularly with regard to the adequacy of the capital.

But there have been a lot of charges out there, especially in the private market for mortgages, and I am not sure how it could, either. Your answer is a good one. I expect one possibility is to maintain the present status or put a cap on the amount of loans so that the growth would have to come from outside. But there still would be a market for some rather large number of mortgages, that is as maturities take place, the existing GSE's could step in to replace the mortgages which they have, which presumably would maintain the institutions in case they might be needed later.

Well, sorry about that digression, Mr. Chairman, but some time we may have to explore that.

Thank you.

Chairman PICKLE. Mr. Gradison, repeat that for me, because I was engaged in conversation at that time.

Mr. GRADISON. Mr. Chairman, I was getting off the subject, and simply asked in particular with regard to Fannie Mae and Freddie Mac, whether we still need them. That is to say, whether the private secondary markets for mortgages has matured to a point where gradually, the GSE's could be phased out. But I acknowledged, Mr. Chairman, in terms of jurisdiction, that isn't for us to determine, but I wanted to take advantage of the expertise of our witnesses, and that is what I was doing.

Thank you, Mr. Chairman.

Chairman PICKLE. Some of the financial leaders of this country, I think Mr. Henry Kaufman has suggested we ought to take away the word "Federal" in front of Fannie Mae or Freddie Mac, and let them be private institutions, as they contend to be. That would remove, perhaps, the implicit responsibility of the Government.

Do you, Mr. Fogel, have any feeling about taking that action?

Mr. FOGEL. No, we are very much aware of the debate. There is no doubt that the GSE's that engaged in housing have served a good public purpose in terms of stimulating the secondary market for housing mortgage and enabled a lot more capital to be put into the industry.

I think it is a very difficult question, because like Mr. Simmons said, one of the questions I would have is, how would you unwind it? There are certainly ways to continue to minimize the extent to which the Government has to be at risk, because of their operations, so you could make them more like a totally private operation, but in the work we have done, we have been generally impressed with the competence, the ability of the GSE's to manage their operations well. It is a very tough issue.

Chairman PICKLE. Well, in my statement at the beginning, I pointed out that GSE's do serve a very useful need as a source of credit. Without them, we may be in great difficulty, but that doesn't mean we should not regulate them, and oversee them, and take certain precautions.

Supervision, certainly, ought to be the first thing we do. Regulation, capitalization, reserves. Those things must be done. We haven't done that. It is shocking to realize that there is practically no regulation of Fannie Mae, and very little of Freddie Mac. Nothing is in the law to prevent them from revising the risks of their activity if they want to. I think we ought to look at that now, in a positive manner. I think we should do that.

When Treasury says to us today that the borrowing of the GSE's is easily obtained, with only a slightly higher rate than even Treasury borrowing, it means that people believe that they have a free ride. They can buy these securities, and they can't lose. They are going to make some money, and that is why people, in many instances, will invest in these highly leveraged companies, because the risk is not there.

I don't know that I want to change too much of that, because I think we need the source of credit. But, we also must recognize that, because of Gramm-Rudman, perhaps more than any other one factor, the GSE's are doubling and tripling. They are growing now because we have the limitations under Gramm-Rudman, and we can expect more and more GSE growth.

Now, if that is happening, and going to happen, then we have got to have better regulations and better control over them, or else the Treasury can expect to inherit an astronomical loss.

Mr. FOGEL. That is true, Mr. Pickle. I would like to emphasize, as I am sure you and Mr. Gradison know, over the years, GAO has continually testified that we think the budget process needs to be changed, and we don't think the Congress or the administration should continue to develop or propose GSE's just to get around putting them on budget, and we have opposed the development of these latest GSE's.

I would also argue that regardless of what we do in the future with GSE's, we think it is important for the GSE's that we have studied, especially for Freddie Mac, Sally Mae and Fannie Mae, there be some increased Federal regulation and oversight.

Chairman PICKLE. Is portfolio lending riskier serving as a guarantor of mortgage-backed securities?

Mr. FOGEL. Yes, it is.

Chairman PICKLE. Is portfolio lending potentially more profitable than guaranteeing mortgage-backed securities?

Mr. FOGEL. Yes, it is. I might let Ms. McCrory explain that.

Ms. MCCRORY. Portfolio lenders are basically exposed to interest rate risk, and depending on how well they manage their interest rate risk, they may take interest rate gambles in attempting to make money. I think we found earlier, early in the eighties, neither the farm credit system or Fannie Mae managed their interest rate risk very carefully, and they were exposed to the volatile changes to interest rates we had in the eighties. As we see it now, they are both doing a better job, but portfolio lending involves those kind of risks, interest risks that are not involved in being a guarantor.

Chairman PICKLE. With respect to the capital adequacy of GSE's, what currently would prevent Freddie Mac from becoming a large portfolio lender if they choose to be?

Mr. FOGEL. Nothing. If Freddie Mac decided it wanted to, it could.

Chairman PICKLE. Well, it is possible—you said nothing. That would be your answer, of course. Is it possible in Freddie Mac's view, that public shareholders would expect its management to expand its portfolio lending operations in order to provide a better return to shareholders?

Mr. FOGEL. I don't think we could speculate on what the shareholders——

Chairman PICKLE. It is possible.

Mr. FOGEL. It is possible, but I think you have to assume management wants to be prudent and doesn't want to take undue risk, and indeed, Freddie Mac has been very conservative in its approach to its operations over the years.

Chairman PICKLE. Yes, but at the same time, the shareholders under Fannie Mae do realize a very good profit, because they don't take any risk. And that is a practice that goes on, and that is just as natural as breathing. So, I am going to suggest that we continue these hearings.

We hope to have before the committee the representative now of Freddie Mac, and Fannie Mae, and the various GSE's, I think they

are entitled to make a statement, or give us any kind of report of their condition at this time, and how they view all these proposals. But, today I think I would like to conclude by saying, you give me the strong recommendation, that in general, you recommend in favor of the Treasury's four principles.

Mr. FOGEL. That is correct.

Chairman PICKLE. And we ought to look at them seriously.

Mr. FOGEL. I should explain, Mr. Chairman, pursuant to FIRREA provisions, we are required to submit our draft report, which we are going to do very shortly to the GSE's and to the Federal agencies for comment, and then we will issue that once we give them time to comment on it. Then, we are required over the next year to provide an additional report.

So, our final report will be due in May of 1991, but our interim report with comments will be issued probably in June in final form.

Chairman PICKLE. I know we get that report in 1991. We may be asking for further reports during this particular year, if we think it is advisable to take the action the Treasury is recommending to us at this time. But, we do know under statute—I think Mr. Gradison commented earlier—at this point, we only have the two reports. It may well be that that can change, but at least we know we will get a full reporting for this year, 1990, and another for 1991.

Mr. FOGEL. That is true. I just say, too, Mr. Chairman, it is interesting, we and the Treasury worked together in terms of getting data from the GSE's, but we have independently reached our conclusions, and I guess my view on this is, anyone that has been through the savings and loan crisis, regardless of where they sit in Government, is much more sensitized to the need to be ahead of the power curve and get information and know about what is going on before the crisis happens.

And I think that the thrust of both what we and Treasury are saying is consistent with a lesson learned from that crisis, and I don't know that we need to wait another year or year and a half before we begin to make some action to get on top of that.

Chairman PICKLE. Well, we didn't call the hearing to make any specific recommendation about what we are going to do with respect to any kind of Federal action or regulation, but I did pose three possibilities. The Treasury has given us four different principles.

Based on that, I think we will be looking at this thing quickly. I thank you very much for your testimony. Thank you all for your testimony.

Mr. FOGEL. Thank you.

Chairman PICKLE. The committee will stand adjourned.

[Whereupon, at 4:02 p.m., the hearing was adjourned.]

[A submission for the record follows:]

June 1, 1990

Comments on Government-Sponsored Enterprises

submitted by

Catherine L. Spain, Director
Federal Liaison Center
GOVERNMENT FINANCE OFFICERS ASSOCIATION

to the

Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

The Government Finance Officers Association (GFOA) would be pleased to have these comments concerning government-sponsored enterprises (GSEs) included in the record of the hearing conducted on May 14, 1990, by the Subcommittee on Oversight of the Committee on Ways and Means. GFOA is a professional association of 12,000 state and local government officials, both elected and appointed, whose responsibilities include all the disciplines related to public finance.

As representatives of state and local government taxpayers and as managers of the public fisc in their respective states and local communities, GFOA's members are concerned about public policies that interfere with potential sources of legitimate state and local government revenue. The charters governing many federal government-sponsored enterprises represent such a policy because they statutorily exempt interest income on the enterprise's debt from taxation by state and local governments. Yet, the GSEs are for the most part privately owned and provide funding for activities that are private in nature.

According to the President's fiscal year 1991 budget proposal, "Outstanding federally assisted credit and insurance have grown faster in the past quarter century than the budget as a whole. ... The fastest growing category of Federal credit assistance has been provided by Government-sponsored enterprises." (See "Budget of the United States Government, Fiscal Year 1991", p. 230.) Investors in privately owned GSE debt receive a double subsidy in the form of federal backing of that debt as well as exemption from state and local income taxes. Among GSE programs enjoying exemption from state and local income taxation are farm credit programs, the Federal Home Loan Bank System, student loans, and, recently, the savings and loan bailout.

State and local governments have endured significant revenue losses because of the proliferation of federal and federally-sponsored debt that is exempt from state and local taxes. A 1986 study by the staff of the Senate Subcommittee on Intergovernmental Relations estimated that approximately $80 billion in interest income earned by private investors in 1985 from federal securities would be exempt from state and local income taxes. They calculated the annual revenue loss for these units of government to be $4.0 billion. That number would be significantly greater now due to the exponential growth in federal debt in recent years. Those figures, of course, include interest on federal debt, which by statute may not be taxed by state and local governments (see 31 U.S.C. Sec. 3124(a)). However, according to the

President's fiscal year 1990 budget proposal, the Office of Management and Budget predicted that by 1990 there would be $259.3 billion in government-sponsored enterprises debt outstanding, a large portion of which would not be subject to state and local government income taxation. The recent savings and loan bailout legislation will add billions to this amount since the Resolution Funding Corporation is authorized to sell debt exempt from state and local taxes.

GFOA has always supported the doctrine of intergovernmental reciprocal tax immunity. The Supreme Court in South Carolina v. Baker has placed on the Congress and the President the responsibility for determining what those immunities will be. We recognize that fact and work in partnership with the federal government to achieve a system which protects the legitimate rights of state and local governments.

You will recall in recent tax legislation, the federal government has restricted the use of tax-exempt debt by state and local governments for activities defined as "private" because of the revenue loss to the government. We believe it is not fair for the federal government to impose revenue losses on states and localities. Their ability to tax earnings on private debt is denied simply by categorizing as "federally chartered" what are really private enterprises.